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TAX REFORM PROPOSALS—XXV

HEARING

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

NINETY-NINTH CONGRESS

FIRST SESSION

OCTOBER 4, 1985

(Entertainment Expenses and Accounting Issues)

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TAX REFORM PROPOSALS—XXV

FRIDAY, OCTOBER 4, 1985

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, DC.

The committee met, pursuant to notice, at 9:30 a.m., in room SD-215, Dirksen Senate Office Building, the Honorable Bob Packwood, chairman, presiding.

Present: Senators Packwood, Chafee, Symms, Long, and Matsunaga.

[The press release announcing the hearing follows:]

[Press Release No. 85-078]

ENTERTAINMENT EXPENSES, ACCOUNTING ISSUES ON FINANCE PANEL AGENDA

Tax reform's impact on business meals and entertainment expenses, as well as on tax accounting procedures, will be the topics of an October 4 hearing before the Senate Committee on Finance, Chairman Bob Packwood (R-Oregon) announced today.

Senator Packwood said the hearing would begin at 9:30 a.m., Friday, October 4, 1985, in Room SD-215 of the Dirksen Senate Office Building in Washington.

"As part of our continuing series on aspects of the President's tax reform proposal, we feel it important to examine business meals, entertainment expenses and the broad issue of tax accounting procedures and practices in the Committee on Finance," Senator Packwood said.

Senator Packwood will preside at the hearing.

The CHAIRMAN. The hearing will come to order, please. We have two principal subjects today, one being business meals and entertainment deductions and the other being methods of tax accounting. We will begin with business meals and entertainment. The first panel will consist of Mr. Fisher, Mr. Juliano, Mr. Salomone, and Mr. Landrieu. I have told Mr. Juliano that I would shift the order slightly and let him testify first, because the Ways and Means Committee is marking up this particular proposal on business meals. As all of you know, Mr. Juliano is not only testifying today, but is one of the principal lobbyists working on that issue. He is going to have to leave and get over to the Ways and Means Committee. So, Mr. Juliano, if you are ready to start, why don't you go right ahead?

STATEMENT OF ROBERT E. JULIANO, LEGISLATIVE REPRESENTATIVE, HOTEL EMPLOYEES & RESTAURANT EMPLOYEES INTERNATIONAL UNION, WASHINGTON, DC

Mr. JULIANO. Thank you, Mr. Chairman. I appreciate your consideration. Without surprising you too much, I will not be my usual articulate self, and I will have to get right to the point, which is very unfortunate. [Laughter.]

And there is another paisan on the panel, so he can stand for me when I have to leave.

The CHAIRMAN. Only you can say that.

Mr. JULIANO. I know. [Laughter.]

The President's proposal on business entertainment expense deductions, both as it relates to business meals and entertainment expenses, is a provision that we strongly oppose and have opposed and will continue to do so. The original proposal in Treasury I was a disaster. This was a semidisaster. They seem to be coming in the right direction but haven't quite gotten the light of day yet. Under the proposal of the President, we would lose anywhere from 50,000 to 80,000 jobs in the eating and drinking establishments, and we do have people who work in the various stadia and arenas throughout the country whose livelihood would be impacted, obviously, if there were a reduction or elimination of the deductibility for tickets to sporting events and theaters and so on. So, we are looking at that proposal in the same light as we have in the past, as being no different than a job loss. It is a substantial job loss at a time when the economy is not growing, I don't think, as quickly as we would all like it to be. And we would be adding more people to the unemployment rolls. Now, the provision which is, I guess, not public, but it has been in the newspapers, so I hope I could comment on—of the 75/50 that is in their package. We had a preliminary estimate done, Mr. Chairman, and that proposal would cost us between 30,000 and 40,000 jobs in eating and drinking establishments, around 15,000 in the hotel section, apart from the typical food and beverage positions, and probably between 1,000 and 2,000 in the sports arenas and the theaters and so on. The reason for the loss beyond the eating and drinking establishments is that the Ways and Means package reinstated the 200 percent per diem for attendance at conventions; and that creates a job loss, in our opinion, beyond the food and beverage aspect and gets to the maids and the bellmen and people in those service positions who are not in food and beverage. We have also indicated that, because of the potential of limited deductibility or a serious deduction, that we feel it will also impact on the income of tip employees all over. That is, people are going to be faced with the prospect of minimizing their deductibility, and that will have a real and direct impact on our members' income. And the original proposal, or the one from the President, we felt with the cap—the 10, 15, 15 proposal, plus the 50 percent cap above, besides the job loss, there would be an impaction of between $1 and $1.50 on the various check averages that we ran. So, we have a double concern because we are talking about a very real threat to the livelihood of a number of people and a total displacement. We are not talking about temporary, but total job loss because these people will be displaced permanently from their respective roles. Also, they seem to feel that there is some serious revenue impact. I, of course—you know me too well—would never question the legitimacy or the viability of the revenue estimators at Treasury or at the Joint Committee; and I know they took the leash off to let them out of the building last night. [Laughter.]

But they now say that the proposal in their package would net $13 billion to the Treasury. One of the things that we would ask you and your distinguished committee is to check into that because we have asked and cannot get accurate information as to just how they arrived at those revenue figures. However, on the job loss, in their proposal, supposedly the most innocuous of the three, when you add what that would mean with the permanent job loss, we are talking about a $4 billion loss to the Treasury, meaning it is more than a wash, because you have people who are permanently displaced who would be working, paying taxes, then going on unemployment or welfare. And when you add up those proposals, it comes to an excess of $4 billion. And so, we would want very much for that to be a part of the record, and we would be willing to work with people; but I don't think that you can say that, you know, there isn't the wash or there is this great revenue impact. And it is the only proposal that I am aware of where there would be such a substantial job loss. So, I don't have anything more to say, and I am sorry that I had to wear a more conservative business suit this morning, and I thank you for your consideration in putting me on, and we will do the best we can. And we look forward to working with you and your committee in the future on this issue.

The CHAIRMAN. Thank you, and good luck in the House this morning.

Mr. JULIANO. Thank you.

The CHAIRMAN. Mr. Fisher.

[The prepared written statement of Mr. Juliano follows:]

STATEMENT OF THE HOTEL EMPLOYEES AND RESTAURANT EMPLOYEES INTERNATIONAL UNION, AFL-CIO REGARDING THE PRESIDENT'S TAX PROPOSALS TO THE CONGRESS ON LEGITIMATE BUSINESS ENTERTAINMENT EXPENSE DEDUCTIONS

PRESENTED TO THE SENATE FINANCE COMMITTEE
CHAIRMAN, ROBERT PACKWOOD
FRIDAY, OCTOBER 4, 1985

SUBMITTED BY:
ROBERT E. JULIANO
LEGISLATIVE REPRESENTATIVE
HOTEL EMPLOYEES AND
RESTAURANT EMPLOYEES
INTERNATIONAL UNION, AFL-CIO

IN BEHALF OF GENERAL PRESIDENT EDWARD T. HANLEY AND THE APPROXIMATELY 400,000 MEMBERS WE ARE PROUD TO REPRESENT, MAY I TAKE THIS OPPORTUNITY TO SAY WHAT A PLEASURE IT IS TO APPEAR BEFORE THIS DISTINGUISHED COMMITTEE AND PRESENT OUR VIEWS ON THE PRESIDENT'S TAX PROPOSALS TO THE CONGRESS REGARDING LEGITIMATE BUSINESS ENTERTAINMENT EXPENSE DEDUCTIONS.

AT THE OUTSET, IT MUST BE NOTED THAT THIS GREAT INTERNATIONAL UNION HAS WORKED DILIGENTLY FOR TWELVE YEARS ON A MYRIAD OF TAX PROPOSALS. WE ARE NOT NOVICES WHEN IT COMES TO THESE MATTERS, AND I FEEL COMFORTABLE IN REITERATING OUR LONGSTANDING POSITION OF WORKING WITH THE CONGRESS TO ACHIEVE MEANINGFUL TAX LEGISLATION. PROBABLY FOR US THE KEY WORD IS MEANINGFUL, SINCE MANY PEOPLE INVOLVED OVER THE YEARS HAVE BEEN LONG ON RHETORIC AND SHORT ON REASON AND FAIRNESS. WE KNOW THAT THE CONGRESS IS ALWAYS THE BEST HOPE FOR LEGISLATION OF THIS NATURE SINCE, AS A BODY, IT REFLECTS THE FEELING OF THE PEOPLE IN OUR PARTICIPATORY DEMOCRACY.

NOR CAN IT BE SAID THAT WE HAVE DUCKED THE TOUGH ISSUES IN FAVOR OF NARROW AND SELFISH INTERESTS. OBJECTIVELY, THE RECORD WILL SHOW A STEADFAST EFFORT TO PROTECT THE LIVELIHOOD AND JOBS OF OUR MEMBERS AS WELL AS THE ENTIRE INDUSTRY, COUPLED WITH A TOUGH BUT REALISTIC APPROACH IN ACHIEVING MEANINGFUL COMPROMISES WHICH CAN ACCOMMODATE THE CONCERNS OF ALL INTERESTED PARTIES. NO BETTER EXAMPLE EXISTS THAN THE PROTRACTED AND EMOTIONALLY CHARGED FIGHT WHICH CULMINATED IN THE TIP REPORTING

COMPROMISE CONTAINED IN TEFRA. IT TOOK A GREAT DEAL OF COURAGE FOR OUR UNION TO ADDRESS THIS ISSUE. THE EASY WAY OUT WOULD HAVE BEEN TO DEMAGOGUE AND POINT ACCUSATORY FINGERS, BUT THAT IS NOT OUR STYLE AND WOULD HAVE BEEN A GREAT DISSERVICE TO OUR MEMBERS.

HAVING ESTABLISHED THE PARAMETERS OF OUR HISTORIC AND CONSISTENT EFFORTS TO ACHIEVE MEANINGFUL TAX LEGISLATION, LET ME STATE OUR FERVENT DESIRE TO WORK WITH THE CONGRESS ON WHAT COULD BE THE MOST IMPORTANT TAX BILL DELIBERATED IN THE HISTORY OF OUR GREAT COUNTRY. WE ARE READY TO BE STATESMANLIKE, BUT WE WILL NOT SUPPORT ANY LEGISLATION WHICH CONTAINS ITEMS THAT CREATE A JOB LOSS FOR OUR PEOPLE AND WHOSE ORIGINS ARE BASED NOT ON FAIRNESS OR FACTUALITY BUT IN SHEER POLITICAL POPULISM AND/OR BLATANT DEMAGOGUERY.

WE VEHEMENTLY OPPOSE THE PRESIDENT'S PROPOSAL ON LEGITIMATE BUSINESS ENTERTAINMENT EXPENSE DEDUCTIONS. ALTHOUGH THERE WAS A SIGNIFICANT CHANGE FROM THE ORIGINAL PROPOSAL IN TREASURY 1, IT ONLY MEANS FOR US THAT THE POTENTIAL JOB LOSS HAS DROPPED FROM 215,000 TO 80,000. ALSO, WE ARE OPPOSED TO THE PROPOSAL ADVANCED BY THE JOINT COMMITTEE ON TAXATION, AS THAT WOULD MEAN A JOB LOSS OF APPROXIMATELY 30,000, AND THE FINAL FIGURES HAVE NOT YET BEEN COMPILED. THAT IS NOT QUITE OUR IDEA OF FAIRNESS, BUT LET'S HEAR WHAT SOME OTHER PEOPLE HAVE TO SAY ABOUT THIS PROPOSAL.

"ALTHOUGH EGALITARIAN AND POPULIST NOTIONS OF EQUITY PROVIDED MUCH OF THE IMPETUS FOR THE KENNEDY AND CARTER ADMINISTRATIONS' ATTACKS ON BUSINESS ENTERTAINMENT, TRAVEL AND ENTERTAINMENT DEDUCTIONS ARE OBJECTIONABLE ON EFFICIENCY GROUNDS AS WELL IF THERE IS A SIGNIFICANT COMPENSATION COMPONENT INVOLVED. THIS PAPER PRESENTS ESTIMATES OF THE DEMAND FOR T&E EXPENDITURES BY PROPRIETORSHIPS AND FINDS A SIGNIFICANT PRICE SENSITIVITY, IMPLYING THAT PRESENT TAX RULES DISTORT BUSINESS EXPENDITURES. PROPOSALS TO LIMIT DEDUCTIBILITY COULD REDUCE THIS DISTORTION, BUT WOULD UNDOUBTEDLY CAUSE SHARP DECLINES IN EMPLOYMENT IN HOTELS, RESTAURANTS, AND SOME ENTERTAINMENT SECTORS."

THIS TEXT IS TAKEN DIRECTLY FROM AN ARTICLE IN THE AMERICAN ECONOMIC REVIEW, DECEMBER, 1983 ISSUE. IT WAS WRITTEN BY CHARLES T. CLOTFELTER, AN ASSOCIATE PROFESSOR OF PUBLIC POLICY STUDIES AND ECONOMICS AT DUKE UNIVERSITY. THE ANALYSIS OF AUDIT WAS PERFORMED UNDER A CONTRACT WITH THE OFFICE OF TAX ANALYSIS, DEPARTMENT OF TREASURY. THE STUDY WHICH HAS JUST BEEN COMPLETED FOR OUR INTERNATIONAL UNION SHOWS THAT THE PROPOSAL CURRENTLY IN THE PRESIDENT'S TAX PACKAGE WILL CAUSE A JOB LOSS OF BETWEEN 50,000 TO 80,000. ALSO, THE JOB LOSS CREATED WOULD RESULT IN PERMANENT DISPLACEMENT, AND THE AVERAGE TIP INCOME PER MEAL WILL DECREASE BETWEEN $1.50 TO $3.00.

THE PRESIDENT'S RATIONALE IS QUOTED FROM PAGE 77 OF HIS PROPOSALS: "MOREOVER, SINCE SOME HIGH-COST MEALS WILL BE REPLACED BY MODERATE-COST MEALS, THE EFFECT ON TOTAL EMPLOYMENT IN THE

RESTAURANT INDUSTRY IS EXPECTED TO BE MODEST." IN OTHER WORDS, THEY ARE ADMITTING THAT THERE WILL BE A JOB LOSS, ESPECIALLY IN THOSE RESTAURANTS THAT ARE SIGNIFICANTLY IMPACTED BY EITHER BUSINESS MEAL PROPOSAL.

HOWEVER, THE TREASURY AND THE JOINT COMMITTEE ON TAXATION FEEL THAT SINCE THE TAX RATES ARE BEING SUBSTANTIALLY LOWERED, FAIRNESS REIGNS. BUT WHAT FAIRNESS AND JUSTICE EXIST FOR A WAITER OR WAITRESS WITH A LOWER TAX BRACKET WHO IS UNEMPLOYED. ALSO, THEIR RATIONALE APPEARS TO BE THAT THE REDUCTION OF THE DEDUCTIBILITY, COUPLED WITH THE LOWERING OF INDIVIDUAL TAX RATES AND CORPORATE TAX RATES, WILL RESULT IN A WASH AND THERE WILL BE NO IMPACT. NOT ONLY IS THIS FALLACIOUS, BUT WHO IN THE CONGRESS WILL SAY IN GOOD FAITH THAT THE LOWER RATES ENACTED INTO LAW WILL REMAIN AT THAT LEVEL IN PERPETUITY.

OUR UNION HAS BEEN FIGHTING THIS PROPOSAL AND SIMILAR PROPOSALS SINCE 1976. WE WILL CONTINUE TO DO SO, AS WE HAVE HISTORICALLY REJECTED ANY LEGISLATION THAT HAS AS ITS BASIS OF ORIGIN MISGUIDED POPULISM AND POLITICAL DEMAGOGUERY. TREASURY HAS ADVANCED THIS PROPOSAL ON THE PREMISE OF TAX ABUSE AND REVENUE IMPACT. TO THEIR CREDIT, THEY NOW ADMIT THAT THERE WILL BE A JOB LOSS. SO THEY HAVE CHOSEN TO FOCUS ON TAX ABUSE, SINCE THEIR REVENUE ESTIMATES BY ANYONE'S MEASURE ARE SOMEWHAT QUESTIONABLE.

WE HAVE CONSISTENTLY STATED, AND REITERATE HERE TODAY, THAT OUR UNION DOES NOT CONDONE TAX ABUSE. THE I.R.S. SHOULD VIGOROUSLY GO AFTER AND AUDIT EACH CASE WHERE FLAGRANT ABUSE EXISTS. YET, THEY SEEM UNWILLING TO DO SO, CLAIMING THAT A NEW LAW IS NEEDED TO EFFECTIVELY AUDIT SUCH ABUSES. RECENTLY, THE NUMBER OF I.R.S. AUDITORS HAS REMAINED FAIRLY CONSTANT OR DROPPED. THIS SEEMS TO BE AN EXAMPLE OF WHERE WE HAVE A HARD TIME SEPARATING RHETORIC FROM REALITY, FACT FROM FICTION, SINCE AGGRESSIVE AUDITS ARE A REAL DETERRENT TO ANY TAX ABUSE.

THE PRESIDENT'S PROPOSAL FOR THE SECTION ON BUSINESS EXPENSE DEDUCTIONS CALLS FOR AN ELIMINATION OF THE DEDUCTIONS FOR ENTERTAINMENT EXPENSES, SUCH AS TICKETS TO SPORTING EVENTS, THEATRES, ETC. THE JOINT COMMITTEE ON TAXATION'S PROPOSAL REDUCES THE DEDUCTIBILITY TO 50 PERCENT. SINCE WE HAVE MEMBERS WORKING IN MANY STADIA, ARENAS, AND THEATRES THROUGHOUT THE COUNTRY, WE ARE OPPOSING THIS PROVISION, FOR THE SAME RATIONALE WHICH APPLIES TO THE AFOREMENTIONED PROVISIONS ON BUSINESS MEALS. IT IS MY FEELING THAT THE PROVISIONS ON BUSINESS MEALS AND ENTERTAINMENT EXPENSES ARE IN THESE PACKAGES NOT FOR FAIRNESS, BUT FOR POLITICAL EXPEDIENCY.

MR. CHAIRMAN, MAY WE TAKE THIS OPPORTUNITY TO COMMEND YOU FOR YOUR LEADERSHIP ON ALL TAX ISSUES. ONE OF THE MOST IMPORTANT ISSUES FACING OUR COUNTRY TODAY IS THE TRADE DEFICIT, AND SURELY SOMETHING MUST BE DONE WITH OUR STAGGERING BUDGET DEFICITS ALSO. ALL OF THESE AREAS ARE VITALLY IMPORTANT, AND

MUST BE ADDRESSED. I BELIEVE A CONSENSUS EXISTS IN THE COUNTRY TODAY FOR TAX REFORM AND FAIRNESS. BUT I BELIEVE FAIRNESS IN THE MINDS OF THE AMERICAN PUBLIC MEANS THAT EVERYONE MUST PAY THEIR FAIR SHARE OF TAXES, BE THEY LARGE CORPORATIONS, SMALL PRIVATE BUSINESSES, WEALTHY INDIVIDUALS, OR ANY OTHER CLASS OF SOCIETY. THIS, I BELIEVE, MORE THAN ANYTHING ELSE WILL RESTORE SOME SEMBLANCE OF TRUST IN THE AMERICAN PEOPLE WITH THEIR GOVERNMENT.

THE KEY INGREDIENT IN ANY OF THE TAX PACKAGES HAS BEEN THE SIMPLIFICATION OF TAX BRACKETS AND RATE REDUCTION. YOU MUST AVOID EVEN THE HINT OF A PROMISE WHICH TAXPAYERS WILL BEGIN TO COUNT ON. IF AND WHEN YOU GO TO CONFERENCE, AND THROUGH CIRCUMSTANCES DICTATED BY ECONOMIC EVENTS OF THAT TIME YOU HAVE TO ALTER THE TAX RATES, THEN YOU AND THE ENTIRE CONGRESS WILL BE PICTURED AS HAVING BROKEN A PROMISE TO THE AMERICAN PEOPLE. SUCH AN EVENT WOULD LEAD TO A BREACH OF PUBLIC CONFIDENCE IN OUR GOVERNMENT WHICH MAY TAKE FUTURE ADMINISTRATIONS AND CONGRESSES YEARS TO OVERCOME.

AS ALWAYS, WE THANK YOU FOR THE OPPORTUNITY TO APPEAR BEFORE THIS DISTINGUISHED COMMITTEE, AND STAND READY TO WORK WITH YOU AND THE ENTIRE CONGRESS TO ACHIEVE MEANINGFUL TAX LEGISLATION THAT WILL MAKE ALL AMERICANS PROUD OF THEIR GOVERNMENT.

STATEMENT OF WILLIAM P. FISHER, EXECUTIVE VICE PRESIDENT, NATIONAL RESTAURANT ASSOCIATION, WASHINGTON, DC

Mr. **Fisher**. Yes, sir. Mr. Chairman, ladies and gentlemen, my name is Bill Fisher. I am executive vice president of the National Restaurant Association, and I thank you, Mr. Chairman, for holding these hearings, allowing me to present the views of the restaurant industry, the Nation's largest employer.

The **Chairman**. Could I interrupt for just a moment, I forgot to announce when we started, all of your statements will be in the record in full. And as you know, you are limited to 5 minutes in your oral presentations.

Mr. **Fisher**. We understand. Thank you. The tax reform proposal submitted by the administration to the Treasury Department calls for limiting the deductions for business marketing meals expenses to $25 per person per meal and only half of any amount spent in excess of the $25 cap. The $25 limit includes the sales tax and tip as well. This type of legislative initiative is not an original one. Others have found the so-called three-martini lunch to be an easy target to generate press coverage. That label is a misnomer and grossly misrepresents a legitimate business expense that fosters economic growth and employment. I must add that, in this day and age of a highly competitive business environment, a literal three-martini lunch would be fatal for a business that wants to maintain its competitive edge. Mr. Chairman, I would like to limit my remarks to two areas: economics and public policy. I go into much greater detail in my written testimony, which has been submitted for the record. The National Restaurant Association recently commissioned Chase Econometrics, a leading economic consulting organization, to investigate the full effect on the U.S. economy of the administration's proposal with and without the business meal provision. Our Chase study analysis is based in part on a study done for the Treasury Department's Office of Tax Analysis and in part on other existing research. In every instance in which the research indicated a range of possible economic effects, our study adopted the more conservative numbers for estimating economic impact on the restaurant industry and the U.S. economy. Our study found that in the first year of enactment—just the first year alone—144,000 food service industry jobs would be lost. Underscore 144,000 food service industry jobs would be lost. Federal, State, and local treasuries would suffer a net loss of $1.6 billion due to lower personal and Social Security tax revenues, coupled with higher unemployment, welfare expenditures. This loss grows to $6 billion by the end of 3 years. Underscore a $6 billion loss at the end of 3 years. Restaurant sales would also be reduced by $3.5 billion. The job losses would severely affect food service employees. Our industry is one of the largest employers of teens, women, and minorities. We employ more minorities in managerial positions than any other industry, and half of all food service managers and administrative personnel are females. These members of our society are those least able to withstand economic dislocation and employment disruption.

I would now like to turn for a moment to the public policy questions which should be addressed. The first goal stated in Treasury I was economic neutrality. A portion of the Treasury I proposal reads: "An ideal tax system would, however, interfere with private decisions as little as possible." Underscore interfere with private decisions as little as possible. Both Treasury I and the administration proposals violated this principle of economic neutrality by deliberately interjecting tax considerations into the business meal decision. An individual who has found the business marketing meal to be an effective tool to enhance business relationships and generate economic growth will be penalized. Anyone who has capital at risk is currently entitled to this deduction in the same manner that valid deductions are allowed for the cost of labor, raw materials, rent, or promotional activities. These are all legitimate expenses of doing business. The Treasury Department hasn't told the business person that it is a good idea to cap deductions for newspaper ads at one-quarter page or that only 30 seconds of a spot on television is deductible, but this proposal places an arbitrary cap on a legitimate business decision—the decision to use the business marketing meal. The owners and operators of thousands of small businesses must depend upon business lunches and dinners as a means of promoting their products or services because their line of business does not lend itself to promotion through newspapers, radio, television, billboards, leaflets, or other marketing tools. In addition, corporate hospitality suites and business-sponsored receptions, which would be completely nondeductible under the administration proposal, are important promotional activities which should also be fully deductible as a cost of doing business. The Treasury Department has categorized these legitimate deductions as abuses, yet nowhere have we seen any documentation of abuses. IRS regulations already prohibit lavish and extravagant expenses as they also require the existence of a business relationship between the business person and the guest. There has been no showing that either of these requirements is being abused.

Mr. Chairman, I would also like to briefly discuss another proposal heard on this issue, one that calls for limiting deductions for business marketing meal expenses to a flat percentage. For example, a 75-percent deductibility and a 25-percent disallowance with no dollar cap. This percentage proposal, which surfaced last week, is just as unsound as the dollar cap proposal for various reasons. First, the sales losses and job losses in the restaurant industry would be just as great, if not greater. Second, the cutbacks which Chase Econometrics tells us would occur in restaurant sales would occur over a much broader spectrum since every business meal would be only partly deductible, not just those exceeding $25. In closing, gentlemen, I want to emphasize that as an industry we believe we have been unfairly singled out for adverse impact by the proposal to cap business meals. We, too, will experience the loss of the investment tax credit, were that to occur. We, too, will experience the slowdown of accelerated depreciation, were that to occur. We ask you: Do not hit us with a double whammy by capping business meals. I thank you.

The CHAIRMAN. Thank you, sir. Mr. Salomone.

[The prepared written statement of Mr. Fisher follows:]

SENATE FINANCE COMMITTEE
HEARING ON TAX REFORM

WRITTEN TESTIMONY ON THE DEDUCTIBILITY OF BUSINESS MARKETING MEAL AND ENTERTAINMENT EXPENSES

PRESENTED BY
WILLIAM P. FISHER
EXECUTIVE VICE PRESIDENT
NATIONAL RESTAURANT ASSOCIATION

OCTOBER 4, 1985

I. INTRODUCTION

The Administration's tax reform proposal calls for limiting the deduction allowable for a legitimate business marketing meal. In addition, it would completely eliminate all deductions for business entertainment other than meals.

The Administration's key argument in support of tax reform is that tax considerations should not influence business decisions. For example, buildings should be built because it makes economic sense, not because they provide a tax shelter. We applaud these goals.

However, when it comes to the business marketing meal, this tax reform proposal violates its own goal of economic neutrality and deliberately injects tax considerations into the business decision making process.

Those responsible for tax policy are attempting to judge better than the marketplace how promotional and goodwill dollars are to be spent. In the process, they are penalizing the business person who has found the business marketing meal to be an effective tool to enhance business relationships.

Many business organizations produce goods and services that are not designed for the mass market and cannot effectively use the mass media to promote their wares of services. The local realtor or insurance agent, manufacturers of products used to make other products, suppliers of specific services to business and industry and others often must use one-on-one contact to market their goods and services. The business marketing meal provides the environment for mutual understanding and respect. Business is enhanced or new business is created.

Anyone who has capital at risk is currently entitled to this deduction (as are his agents) just as he or she is entitled to deductions for the cost of labor, raw materials, rent, or promotional expenses. They are all legitimate expenses of doing business.

The business marketing meal, hospitality suites and business sponsored receptions are all part of the marketplace. (The last two would be completely non-deductible under the proposal.) If businessmen and women did not believe these expenditures were good for their businesses, they simply would not be made. If a business is frivolous, lavish or extravagant in the utilization of these promotional tools, the free market has a ready answer: these businesses do not remain competitive--they change their ways or go out of business.

Some members of the public--and some in the Treasury Department--apparently believe the business marketing meal is simply an uncontrolled waste of money. President Carter's "Three Martini Lunch" comments helped foster this attitude.

However, that belief flies in the face of common sense and good business judgment. Corporations budget their dollars for business entertainment just as they budget every other business dollar. The budget for business marketing meals competes for priority with every other budget item. Whether that budget process is formal or informal is irrelevant. The bottom line for most businesses is: If it isn't good for business, it isn't done.

Most companies control business marketing meal costs as they control all other costs of doing business--carefully.

II. ECONOMICS

Chase Econometrics examined the tax reform proposal with and without the business meal limitations. Their study contains findings as to its impact on workers and firms in the restaurant industry, on other parts of the economy, and on the budgets of federal, state, and local governments.

Effect upon Industry and Employment

Business meals purchased either for travel or marketing account for about one-third of total U.S. restaurant sales. Business marketing meals account for just over one-fifth of restaurant sales nationally and a substantially higher share of restaurant sales in major cities. Business meals are a recognized, productive cost of doing business. In 1985, business and professional firms will spend over $30 billion for marketing meals in U.S. restaurants, supporting some 1.3 million restaurant jobs.

The President's proposal would place a cap of $25 per person (including taxes and tips) on business marketing meal costs which could be deducted as a normal business expense. Amounts above the cap would be only 50 percent deductible. The cap would not be indexed for inflation, so the share of business meals affected would increase over time.

Based on a nation-wide survey of 55,000 households by NFO Research, approximately 18 percent of today's business marketing meal occasions, accounting for 43 percent of total dollars spent nationally, exceed the proposed cap. With 4 percent inflation, the share of business meals affected by the cap would rise to 25 percent of meal occasions, in 1988 accounting for 54 percent of total dollars spent nationally. In major cities, where rent and other costs are higher and average restaurant tabs are correspondingly larger, the impact would be much greater.

According to the latest national survey of business meal and lodging costs by the accounting firm of Laventhol & Horwath, the average cost of an evening meal at a typical hotel restaurant is already above the proposed cap in 49 major U.S. cities. Laventhol & Horwath based its survey (Table I) on a downtown hotel restaurant dinner consisting of shrimp cocktail, prime rib and vegetables, ice cream and coffee. No alcoholic drinks were included. The survey showed that even in a city like Little Rock, the average cost of a business dinner could easily exceed the proposed cap.

TABLE I
LIST OF CITIES WHERE DINNER COST (Including Tax and Tip) IS ABOVE $25.00

	CITY	DINNER	15% TIP	TAX	TOTAL
1	New York	$38.36	$5.75	$3.16	$47.27
2	Washington, DC	28.28	4.24	1.70	34.22
3	Santa Barbara	26.57	3.98	1.73	32.28
4	Dallas	26.42	3.96	1.62	32.00
5	San Francisco	26.04	3.91	1.69	31.64
6	Chicago	26.03	3.90	1.56	31.49
7	Buffalo	25.50	3.82	2.04	31.36
8	Seattle	25.28	3.79	2.00	31.07
9	Houston	25.53	3.83	1.56	30.92
10	Newark	25.33	3.80	1.52	30.65
11	New Orleans	24.53	3.68	2.21	30.42
12	San Antonio	25.15	3.77	1.41	30.33
13	Nashville	24.88	3.73	1.37	29.98
14	Austin	24.57	3.68	1.26	29.51
15	Philadelphia	24.09	3.61	1.44	29.14
16	Columbus	24.08	3.61	1.44	29.13
17	Atlanta	24.20	3.63	1.21	29.04
18	Wilmington	24.29	3.64	1.09	29.02
19	Richmond	24.33	3.65	0.97	28.95
20	Los Angeles	23.81	3.57	1.55	28.93
21	Minneapolis	23.81	3.57	1.43	28.81
22	Baltimore	23.91	3.59	1.19	28.69
23	Dayton	23.52	3.53	1.41	28.46
24	Denver	23.40	3.51	1.54	28.45
25	Rochester	23.16	3.47	1.62	28.25
26	Boston	23.42	3.51	1.17	28.10
27	Detroit	23.41	3.51	0.94	27.86
28	San Jose	22.58	3.39	1.58	27.55
29	Miami	22.80	3.42	1.14	27.36
30	Cleveland	22.47	3.37	1.46	27.30
31	Hartford	22.20	3.33	1.66	27.19
32	Phoenix	22.63	3.39	1.13	27.15
33	Tulsa	22.33	3.35	1.34	27.02
34	Corpus Christi	22.40	3.36	1.15	26.91
35	Fort Lauderdale	22.33	3.35	1.34	26.80
36	Pittsburgh	21.75	3.26	1.30	26.31
37	Norfolk	22.08	3.31	0.88	26.27
38	Baton Rouge	21.40	3.21	1.50	26.11
39	Lexington	21.67	3.25	1.08	26.00
40	Little Rock	21.65	3.25	1.08	25.98
41	Fort Wayne	21.61	3.24	1.08	25.93
42	Cincinnati	21.50	3.22	1.18	25.90
43	San Diego	21.36	3.20	1.28	25.84
44	St. Louis	21.06	3.16	1.26	25.48
45	Greensboro	21.32	3.20	0.96	25.48
46	Indianapolis	21.05	3.16	1.05	25.26
47	Albany	20.70	3.10	1.45	25.25
48	Columbia, S.C.	21.00	3.15	1.05	25.20
49	Memphis	20.51	3.08	1.59	25.18
50	Albuquerque	20.90	3.13	0.97	25.00

Sources: Dinner cost, "Corporate Travel Index, 1985," Laventhol & Horwath. Local sales tax and tip computed by NRA.

As one can see, if 50 cities are in this class today, it will not be long until most commercial centers are affected by this proposal. It should be noted that the costs of the meals in downtown hotels are somewhat below those of the top independent restaurants in a city.

The actual dollar value of business meal expenditures above the proposed cap would rise from about 17 percent today to about 22 percent in 1988 just due to inflation. When tax and tip are included along with inflation, the actual menu price of a business meal in 1988 would have to be less than $17.15 in today's prices to avoid the cap.

Reducing the deductibility of business meal costs above the cap to 50 percent will make business meals relatively more expensive than other marketing expenses that continue to be fully deductible. Since business meal purchases are extremely price sensitive, the result will be a sharp reduction in meal expenditures affected by the cap and a corresponding reduction in restaurant sales and employment. Studies prepared for Treasury's Office of Tax Analysis indicate that spending on business marketing meals declines by two to four percent for every one percent increase in their relative price. Reducing the deductibility of meals over the proposed cap to 50 percent is equivalent to an increase in their relative price of 24 percent. Hence, the proposed $25 per person cap would result in a reduction of 50 to 85 percent in purchases of business meals above the cap price and in a drop in total business marketing meal purchases on the order of 9 to 15 percent nationally. The drop would be much greater in metropolitan areas where the number of business meals above the cap is proportionately much larger.

The impacts of the proposed cap shown in Table II are based on the low-end estimate of a 9 percent reduction in business meal purchases nationally, compared with the level of business meal purchases which would occur under "Treasury II" without the business meal cap. During the first three years--1986-1988--direct losses in restaurant sales would total $11.9 billion and direct losses in restaurant employment would total nearly 460,000 person-years. The reduction in restaurant sales would produce a direct reduction in state and local sales tax receipts of over $700 million.

When indirect effects are taken into account, using the Chase Econometrics U.S. Macroeconomic Model, total U.S. employment would be reduced by 580,000 person-years during the first three years. Federal corporate taxes would rise about $5.4 billion during this period, but this increase would be more than offset by lower tax receipts from individual taxpayers and higher expenditures due to the increased unemployment created by the cap. Federal receipts from personal income taxes and social security taxes would fall by $2.2 billion and $2.4 billion, respectively, while transfer payments would rise by nearly $2.4 billion. As a result, the net financial position of the federal government would be worsened some $2.8 billion in the initial three year period if the cap is imposed.

Impact upon State, Local and Federal Revenues

The impact on state and local governments is even greater. Nationally, when indirect effects are taken into account, total state and local tax receipts would be reduced by $2.8 billion in the initial three-year period. When higher expenses due to higher unemployment are factored in, the net financial position of state and local governments would be worsened by more than $3.2 billion.

Even though Treasury claims the business meal cap has only a "small revenue impact," the cap widens the federal deficit and substantially worsens the adverse impact on state and local governments. When the impacts on federal, state, and local budgets are combined, the total net deficit during the initial three-year period is just over $6 billion.

The adverse effects of the proposed business meal cap are aggravated further by their timing relative to the proposed rate reductions included in other parts of "Treasury II." The cap would go into effect on January 1, 1986, while the rate reductions would be delayed until July 1, 1986, or perhaps even later. The impact of the cap is very sensitive to the marginal tax rate of individual and corporate taxpayers at the time the cap is activated. The higher the marginal tax rate, the greater the shift in the relative price of business meals when a cap on deductibility is imposed. Imposing the cap at the current marginal tax rates six months before the proposed rate reductions take effect worsens the impact by over $300 million in additional lost restaurant sales during 1986 and some 13,000 additional jobs lost in the restaurant industry during 1986.

The job losses would severely affect foodservice employees. Our industry is one of the largest employers of teens, women and minorities. Our industry employs more minority managers than any other industry, and half of all foodservice managers and administrative personnel are women. These are members of our society least able to withstand economic dislocation.

TABLE II

ECONOMIC IMPACT OF BUSINESS MEALS CAP UNDER "TREASURY II"

(with meals cap versus without)

	1986	1987	1988	Total
Direct Impacts on Sales, Employment, and Tax Receipts*				
SALES OF MARKETING MEALS ($ Billions)				
Total Projected Sales	33.2	36.8	40.7	110.7
Sales Lost Due to Cap	-3.5	-3.8	-4.6	-11.9
Sales Retained	29.7	33.0	36.1	98.8
DIRECT EMPLOYMENT (Thousands)				
Eating & Drinking Establishments	-144	-146	-166	-457
DIRECT TAX RECEIPTS ($ Billions)				
Federal Tax on Meals Over Cap	.25	.28	.26	.79
State & Local Sales Tax on Meals	-.21	-.23	-.27	-.71
Macroeconomic and Government Revenue Impacts, including Indirect**				
GNP ($ Billions)				
Current Dollars	-1.7	-3.31	-5.84	-10.85
1972 Constant Dollars	-.65	-1.1	-1.57	-3.32
EMPLOYMENT (Thousands)				
Total U.S.	-150	-190	-240	-580
Wholesale & Retail Trade	-150	-160	-190	-500
Unemployment Rate (Percent)	.09	.1	.11	na
FEDERAL BUDGET ($ Billions)				
Personal Income Taxes	-.51	-.69	-.99	-2.19
Corporate Income Taxes	.85	.87	3.63	5.35
Social Security Taxes	-.53	-.73	-1.06	-2.32
Total Federal Taxes	-.19	-.55	1.58	.84
Transfer Payments	.87	.76	.72	2.35
Federal Net (deficit)	-.87	-.79	-1.17	-2.83
STATE & LOCAL BUDGET ($ Billions				
Personal Income Taxes	-.34	-.49	-.7	-1.53
Corporate Income Taxes	.13	.12	.11	.36
Indirect Business Taxes	-.37	-.52	-.73	-1.62
Total S&L Taxes	-.58	-.89	-1.32	-2.79
State & Local Net	-.69	-1.07	-1.46	-3.22

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* Estimates prepared by Shriner-Midland Company.

** Macroeconomic simulations by Chase Econometrics.

IV. COMPLIANCE

A staff study of tax reform by the Joint Economic Committee, published November 29, 1984, identified "compliance" as one of the major principles upon which to judge tax reform proposals. The Joint Committee defined compliance by stating, "The tax system should minimize the incentive and opportunity for taxpayers to evade taxation by underreporting income or overstating deductions and exemptions."

Referring to the compliance problem of our present tax system, the committee print states that "tax reform proposals could improve compliance in two ways -- by eliminating preferences that taxpayers can misuse to shelter income and by reducing tax rates to reduce the incentive to cheat. Should this fail to make a significant improvement in compliance, tax reform will have to be supplemented by increased enforcement." (S. Print 98-253, Nov. 29, 1984, p. 20)

The provisions limiting deductions for legitimate business marketing meal expenses are supported by the Treasury Department as a means of promoting compliance by increasing the "perceived fairness" of the tax code. Since many workers do not make use of business marketing meals to promote themselves or a product, Treasury officials disapprove of such promotional activity by others. Authors of this provision point to a series of field hearings conducted during 1984, where complaints were heard from citizens about entertainment costs being written off as business-related. These same objections could be directed at the large and well-furnished office suites maintained by many companies in high-rent cities, or the use of expensive hotel suites by business executives conducting business away from home.

These business people, however, conduct business in this manner because that is what is expected in their particular lines of business and at the level at which they compete. Most are not operating in a manner calculated to overstate deductions. Therefore, Treasury's proposed caps and limitations do not get at the real compliance problems of overstating deductions and underreporting income. They are merely a political attempt to address a "perception" of unfairness which arises out of both legitimate and illegitimate uses of expense account spending.

In order to get at the real abuses in business entertainment and business marketing meal occasions, legislation or committee language would have to address the specific problem of overstatement of deductions. This overstatement occurs if and when a taxpayer claims a deduction for a business marketing expense which is actually a personal expense that is not business-related. These types of abuses can only be identified and reduced through increased use of audits, and increased publicity surrounding the results of audits.

In fact, the IRS does have the authority under existing law and regulations to disallow deductions for expenses which are not justified as business related, or which are lavish and extravagant.

The IRS has successfully brought cases to deny improperly taken deductions. Both sections 162 and 212 of the Internal Revenue Code require that the expense must be "ordinary and necessary" in order to be deductible.

The Treasury proposal in fact creates a compliance nightmare of its own. It vastly increases the difficulty of recordkeeping by forcing the honest business person to sort out, and keep track of, that portion of business marketing meal expenses which are fully deductible and that portion which is partially deductible.

Unfortunately, the opportunity for fraud is increased. If we see "tables for two and checks for three," or the invention of several imaginary dinner guests as the answer to the paperwork and deductibility dilemma, can we say this will improve the public's "perception" of fairness? The answer, of course, is no.

V. OTHER PROPOSALS

Another proposal which has been raised calls for limiting deductions for business meal expenses to a flat percentage, such as 80% of all amounts spent, without any dollar guidelines.

This proposal is just as unsound as the Administration proposal for various reasons. First, the sales losses and job losses in the restaurant industry would be just as great, if not greater. Second, the cutbacks which Chase Econometrics tells us would occur in customer traffic would occur across a much broader spectrum, since every restaurant meal would be only partly deductible, not just meals which exceed $25.

VI. CONCLUSION

The Treasury Department argues that it is unfair for a "limited class of taxpayers" to engage in activities which have some element of personal consumption. However, the "limited class of taxpayers" who use the meal as a marketing tool are any taxpayers, or their agents, who have capital at risk.

As our elected representative to the U.S. Senate, you understand the workday of the entrepreneur. Those who serve in Congress, like those who compete in the marketplace, whether seeking voter exposure or business expansion, do not punch time clocks and cannot always control their hours of work.

When a businesswoman engages in a business lunch, it means her business day is extended through the lunch hour. When a businessman engages in a business dinner, it means he didn't go home at five o'clock when the factory whistle blew.

The number of jobs at stake over this issue is enormous. The deductibility of the business marketing meal affects not only those 144,000 foodservice positions that would be lost in the first year of enactment but thousands of other American workers whose jobs were created or retained because of a contract closed over a business marketing meal.

In closing, Senators, I ask you: Is it responsible and productive tax policy to enact legislation which reduces an industry's sales volume, eliminates jobs and decreases federal, state and local revenues all in the name of "populism?" I respectfully submit to you that the answer has to be an emphatic no.

Thank you, Mr. Chairman, for holding these hearings and permitting our views to be heard.

STATEMENT OF ALPHONSE W. SALOMONE, SENIOR VICE PRESIDENT, HILTON HOTELS CORP., NEW YORK, NY, ON BEHALF OF THE AMERICAN HOTEL AND MOTEL ASSOCIATION

Mr. SALOMONE. Good morning. My name is Alphonse Salomone. I am senior operating vice president of the eastern region for Hilton Hotels Corp. I am speaking today as a representative for the American Hotel and Motel Association. We would first like to comment on the ban of deductibility on entertainment expenses, whether total, as proposed by the President, or partial, as proposed by Mr. Rostenkowski. These proposals are explained as limited deductions for entertainment expenses, such as tickets to professional sporting events, tickets to the theater, and similar activities. However, the proposed ban on entertainment expense deductions will have an adverse impact directly upon the hotel and motel industries. The examples of "entertainment expenses" may leave the impression that ticketed events are the only type of entertainment expenses which will be restricted. Nothing could be further from the truth. The lodging industry receives a substantial amount of its annual revenue from business receptions and hospitality suites held during conventions, trade shows, and business meetings, events which would fall under the definition of entertainment expenses. These promotional devices are similar to commercial ads on television, radio, and in various print media, with one essential difference: they are targeted to the group most likely to become customers. These targeted promotional activities, which include banquet functions carried out in a legitimate business setting, such as at a convention, have only one purpose, and that is to promote the business that sponsors the activity and to enhance its ability to sell its goods and services. Yet the various tax reform proposals draw an arbitrary distinction between these two types of promotional activities, retaining full deductibility for any level of expenditure for advertising promotions in the media and completely eliminating the deduction for targeted personal techniques employed at conventions and business meetings. Since there is no valid distinction to be made between these types of promotional activities, they should continue to be accorded fair and equal treatment under the tax law by retaining their full deductibility under the current standards in the Internal Revenue Code. Business meals are another form of targeted promotional activity, which should be afforded the same treatment as business receptions and mass media advertising.

The proposals carve out an exception to the ban on entertainment expenses for business meals, either capping the amount which may be deducted for a business meal or setting a percentage limitation. These restrictions are unacceptable and unworkable impositions on the lodging and food service industries and would create administrative nightmares for all businesses who must comply. Another important fact to be considered, particularly in these times of astronomic trade deficits, is that enactment of these proposals will give another unfair advantage to foreign competitors who are not faced with either caps or arbitrary percentage limitations on business meal deductibility or a ban on all other entertainment expense deductions. Also, while the administration projects revenue gains from these entertainment expenses changes, these gains are strictly conjectural with no proven basis in fact. We feel that increases in unemployment insurance and welfare costs, combined with losses in Federal revenue, will more than offset any conjectural calculations of revenue gain. Even more important than the tens of thousands in lodging jobs which are in jeopardy from these proposals are the people who will lose their jobs. For some, their jobs may prove the starting point in a career, but for many these jobs represent their only means of gainful employment. If we take jobs away from these people, they will have little expectation of gaining other employment. What good are lower tax rates to those who lose their jobs as a result of tax reform?

It is ironic that the most persuasive summary statement of the effect of this on the current law and the disastrous impact of a curtailment of these legitimate deductions was made by the very man who now has set his seal of approval on these changes. In a letter to the American Hotel and Motel Association, dated October 18, 1980, then-candidate and now President Ronald Reagan wrote:

> The tax law already disallows tax deductions for personal expenses, as opposed to business expenses. The business meal, business travel, etc. are an essential part of the competitive business in the United States. The tourism industry, especially in its hotels, motels, and restaurants, is one of the country's largest employers. A curtailment of tax deductions for business meals and travel would put thousands of people out of work and hurt every aspect of tourism, both big business and small. I believe that present law, properly enforced, can encourage business opportunities and restrict abuses.

We, too, believe the current law contains the proper balance of freedom of business, control of the Government, and that it is adequate to police any isolated instances of tax abuses which may occur. We strongly oppose any additional restrictions on business entertainment deductions. I will be pleased to answer any questions.

The CHAIRMAN. Thank you, sir. Mr. Secretary, it is good to have you with us again.

[The prepared written statement of Mr. Salomone follows:]

Statement of the
American Hotel & Motel Association
Before the Senate Finance Committee
On the Deductibility of
Business Entertainment Expenses

October 4, 1985

On behalf of the membership of the American Hotel & Motel Association we appreciate the opportunity to appear before the Senate Finance Committee and offer testimony on the issue of tax reform and its impact on our industry.

The American Hotel & Motel Association is a federation of hotel and motel associations located in the fifty states, the District of Columbia, Puerto Rico and the Virgin Islands. The Association has a membership of over 8,700 individual hotels and motels which represents approximately 1.25 million rooms. Inclusive in our membership are all of the major hotel and motel chains. The lodging industry employs on the average, 1,210,000 with an annual payroll exceeding $8.6 billion. In addition, the lodging industry pays over $3.3 billion in federal taxes.

This testimony today is directed primarily towards two provisions contained in The President's Proposals to the Congress for Fairness, Growth and Simplicity. The first provision would eliminate any deduction for entertainment expenses incurred by a businessman in the pursuit of his livelihood. The second would allow a limited deduction for business meal expenses of $25 per person per meal, including tax and gratuity and one-half of any amount over $25. Almost two-thirds of all lodging revenue is generated by the business traveler, whether attending a convention, trade show or business meeting or traveling alone on company business. When the ability of the businessman to conduct certain promotional aspects of his business is threatened, so too is the lodging industry threatened.

While our testimony will concentrate on these two items we wish to mention that many recommendations in the President's proposal will have a significant impact on major segments of our industry. These proposals include the elimination of the investment tax credit; the lengthening of the depreciation schedules for buildings and the depreciation recapture rule; the extension of the at-risk rules for interest deductibility to real estate transactions and the limit on deductibility of interest, in particular the inclusion of non-rental second homes or condominiums. The President's tax reform proposal contains radical changes for all parts of the lodging industry. These changes impact our industry whether it is in the planning and construction phase where incentives for investors have been stifled, the operation phase where return of vitally needed capital has been slowed or in the marketing phase where the goods and services we offer to the public are threatened by the elimination or limitation of the deductibility of long-time legitimate business expenses.

We also wish to mention that the tax reform proposal offered for consideration by House Ways and Means Committee Chairman Dan Rostenkowski (1) contains a different treatment of entertainment expense deductibility and (2) attempts to re-impose a limit on the business traveler's expenses based on a government employee's per diem rate. While this Committee may not consider that proposal to be before it, we must bring to the Committee's attention the fact that the partial deduction for business entertainment expenses proposed therein is no more acceptable to our industry than the total ban proposed by the President. A legitimate business promotional expense is entitled to full deductibility under present law and distinctions should not now begin to be made in that deductibility based on different types of promotional expenditures. Similarly, the proposed percentage deduction on business meals in the House Ways & Means Committee draft proposal is no more acceptable than the President's proposed meals cap. We feel that any restrictions on these deductions is unnecessary and unwarranted.

One final proposal in Mr. Rostenkowski's plan deserves attention here. His draft proposes to limit the deductibility of travel expenses for business persons attending a trade convention or seminar to 200% of the federal per diem rate for food, lodging and incidentals. The President saw fit to eliminate a similar proposal from the November Treasury plan and nothing has occurred to change the wisdom of that decision. Any proposal which attempts to restrict or measure spending for private business purposes by reference to a government spending schedule is totally inappropriate in our free enterprise system. Private enterprise has opened up millions of job opportunities based on the historical recognition that it must have the tools to promote and market its products and services. The Government sector's function can in no way be compared to that of the private sector and the tax laws of this country should recognize this fact. The inadequacy of the federal per diem system to reimburse federal employees is well known and has been the subject of recent House hearings to correct these injustices. This proposal is simply not worthy of legislative attention.

Industry Background

We would first like to present the committee with some basic information on our industry and the key role it plays in our economy, particularly in the area of revenue, jobs and taxes. This data comes from various sources including the Bureau of Labor Statistics, the U.S. Travel Data Center, and the national accounting firms of Laventhol & Horwath and Pannell Kerr Forster. These latter two sources gather and release to the public numerous documents on the lodging industry and are generally acknowledged to be reputable information sources for our industry.

As of the end of 1983 there were an estimated 53,600 lodging establishments operating in the United States. The scope of these operations range from small individually owned properties of 10 rooms, in many instances true "Mom and Pop" operations, to the corporate owned, operated and or managed facilities with over 1,000 rooms, many part of nationally recognized chain operations, which are capable of meeting the business needs of even the largest conventions and trade shows. Some facilities operate only seasonally while the rest are operated all year round. Taken together these properties offer a daily amount of available rooms in excess of 2,714,000 which generated annual sales of approximately $33.3 billion in 1984. Lodging industry revenue for 1984 may be broken down as follows:

Revenue Category	Total Amount (millions)	Business Related Amount (millions)
Rooms	$19,686	$12,599
Food	8,208	5,253
Beverage	3,170	2,029
Other	2,302	1,473
TOTAL	$33,366	$21,354

The average operation ranges in size from approximately 50 to 60 units. The larger properties, those averaging over 100 rooms, comprise only 12 percent of the total number of industry operations but represent approximately 48 percent of the total number of available guest rooms in the industry. This segment of the lodging market generates approximately 68 percent of the total receipts and employs approximately 66 percent of the total industry workforce. For the average traveler the lodging industry today is typified by large properties which are, in turn, predominantly owned, managed or affiliated with a hotel or motel chain. Chain operations have been estimated to include 29 percent of the total number of U.S. properties and 63 percent of the total number of available guest rooms in the United States.

Annual average occupancy for the lodging industry for 1984 is estimated to be approximately 67 percent.

The lodging industry is also a major employer. In 1984 approximately 1,210,000 people were employed in the lodging industry on either a full or part-time basis. The lodging industry created approximately 24,000 new jobs in 1984 alone. Of these, a major percentage are employees in entry-level positions, often characterized as unskilled labor, a group which traditionally makes up the largest percentage on the unemployment rolls. The following chart will give a clearer picture of the labor mix in the lodging industry:

Job Category	Number of Employees	Percentage of Total
Professionals and managers	97,056	8.0
Sales and clerical	190,412	16.0
Produce and maintenance	84,924	7.0
Service:		
Housekeeping	339,696	28.0
Food and beverage	436,752	36.0
Other	60,660	5.0
TOTAL	1,209,500	100.0

These many workers serve the varied needs of the lodging market. The demand for lodging, food and beverage, and ancillary facilities may be segregated by the purpose of the traveler. A typical breakdown segregates the market into business and convention, tourist and "other" market segments. The following chart shows the percentage of business generated by each of these segments for 1984:

All Establishments

Market	Percent of Total
Business and conventions	65.8
Tourist	27.4
Other	6.8
Total	100.0

The conclusion is inescapable that the business traveler and business use of lodging facilities are the mainstay of the industry. Any tax proposal that seeks to limit, eliminate, or in any way chill the exercise of legitimate business activities in lodging facilities must be spoken out against for the health of the industry and to continue its ability to serve non-business use as well as business use.

The Tax Proposals of Concern to the Industry

The first proposal to be considered is the total ban on the deductibility of entertainment expenses. On page 76 of the President's proposal is contained the statement "No deduction would be allowed for entertainment activity expenses."

In these few short words is contained a judgment which will have a far reaching effect on a substantial portion of the lodging industry, in particular the foodservice element and its many employees that provide service at tens of thousands of conventions, banquets, trade shows and business meetings annually.

In its analysis of this provision the President's proposal states "the proposal would completely eliminate deductions for entertainment expenses such as tickets to professional sporting events, tickets to the theater, the costs of fishing trips, and country club dues."

In light of the examples provided by the Administration, it is necessary to explain the lodging industry's concern over this seemingly inapplicable section. The examples of "entertainment expenses" cited in the President's proposals and discussed in the press leave the impression that these are perhaps the only types of entertainment expenses covered in the Internal Revenue Code. Nothing could be further from the truth.

Even a cursory scanning of the relevant sections of the Internal Revenue Code and Regulations, and the case law and commentaries on those sections leads one to the conclusion that "entertainment expenses" is a broadly defined term including numerous promotional activities which are essential to the growth and maintenance of business sales, and that the IRS is constantly striving to expand its definition of "entertainment expense" and limit its use in a business context.

The question arises, then, how does this proposal impact on the lodging industry, and in particular on the foodservice element thereof. The answer lies in the many ways business currently promotes itself. We are all familiar with the commercial ads on television, radio and in various print media that businesses use to make many people aware of their goods and services and to entice them to utilize these items. These efforts have been recognized, in the words of the Internal Revenue Code, as ordinary and necessary business expenses and as such have been deductible from the gross income of a business without limitation in deriving net income on which taxes would be assessed. This in fact is the very basis of our corporate tax system: what is spent to promote the business and make it grow is not taxed.

However, business has another technique of legitimately promoting itself. It has a more targeted method, frequently used at conventions, trade shows and business meetings where sellers and their buyers are gathered together; gatherings which frequently occur in the hotels and motels of our country.

These targeted promotional activities are of various types but have only one purpose, to promote the business that sponsors the activity and to enhance its ability to sell its goods and services. Some of these activities involve the service of a formal meal, be it breakfast, lunch or dinner. Just as frequently they occur outside normal meal times and include a limited service of food and beverage in a "stand up" atmosphere. But, whether at a meal or a reception the attendee knows that the purpose for attendance is to absorb the message of the sponsor in a more relaxed and comfortable atmosphere and that the sponsor expends the funds for these activities with the expectation of making itself better known and increasing its business.

It has long been recognized by the IRS that a wide range of expenses are part and parcel of the legitimate promotion of business and are entitled to full deductibility. Examples of these activities include banquet functions carried out in a legitimate business setting such as at conventions, and promotional activities such as receptions and hospitality suites held in conjunction with trade shows and business meetings.

Yet, by its language the President's proposals would appear to draw an arbitrary distinction between certain types of promotional activities; retaining full deductibility for any level of expenditure for advertising promotion in the media and completely eliminating the targeted personal technique employed thousands of times every day at conventions and business meetings held in lodging establishments throughout the country. Since there is no valid distinction to be made between these types of promotional activities, they should continue to be accorded fair and equal treatment under the tax laws by retaining their full deductibility under the current standards in the Internal Revenue Code.

We strongly oppose any changes in the tax treatment accorded to entertainment expenses involving receptions and hospitality suites and similar functions because of the strong and legitimate business focus which exists at these events.

We call on this Committee to eliminate any such proposals from tax reform legislation it may pass.

We address ourselves in this argument only to the impact that the denial of "entertainment expense" deductions will have on the lodging industry. In doing so, we neither draw conclusions nor create inferences toward the myriad other type of entertainment deductions impacted by the broad sweep of this proposal.

The second proposal which strikes at the operation of our lodging facilities is the proposal to limit the deductibility of business meals. The language of the President's proposals is as follows:

"A deduction would be allowed for the cost of ordinary and necessary business meals furnished in a clear business setting (as defined in Treasury regulations). To the extent the total cost of a business meal exceeds $25, times the number of persons participating in such meal, 50 percent of such excess would be nondeductible. The meal cost limitation would include gratuities and tax with respect to the meal."

This language carves out an exception to the total ban on entertainment expenses discussed above but proposes to cap the amount which may be deducted for a business meal. While the Administration proposal describes this cap as "intentionally quite generous", it is nevertheless an unacceptable and unworkable imposition on the lodging and foodservice industry.

Federal caps imposed on deductibility are subject to erosion over time by inflation and later reduction by legislative fiat. The issue is not whether the cap is generous today, or what percentage of foodservice facilities will be affected. The issue is whether a promotional business meal should be treated any differently than any other promotional business activity by limiting its deductibility.

The fact that some business meals may exceed a fixed cap or an arbitrary percentage does not mean these activities are being used for tax abuse or that their tax deductibility should be capped or eliminated. The broad range of service available in the lodging industry and its foodservice component was developed in response to appropriate business demand. This self-regulating aspect of business should not be tampered with.

Another important fact to be considered, particularly in these times of astronomical trade deficits is that enactment of these proposals will give another unfair advantage to foreign competitors who are not faced with either a cap or arbitrary percentage limitation on business meal deductibility or a ban on all other entertainment expense deductions.

We are convinced that controls on business expense deductibility have been and continue to be a legitimate part of the Internal Revenue Code and Regulations. Moreover, we are convinced that there presently exists in those bodies of law sufficient authority to enforce appropriate limits and control any abuse which may be feared to exist.

The present law states that "ordinary and necessary" business expenses are deductible. Those few words have engendered substantial litigation and their meaning has been refined and clarified over the years. There can be no serious doubt that these words represent an adequate standard by which business expenses including entertainment and meal expenses can be measured. In addition, the law already contains an additional upward limit on the amount that can be spent on entertainment expenses, a limit not existing for any other business deduction. The law specifically states that a deduction will not be allowed for entertainment expenses that are "lavish or extravagant." Thus, the clear intention of Congress, expressed in law already on the books, is that extraordinary and unnecessary business expenses are not deductible. There is no problem with the law. If there is any problem, it is in the enforcement of the law. Businesses should not be denied deductions, have arbitrary percentage limitations or have caps placed on them because of vague feelings on the part of some bureaucrats that someone is getting away with something.

This attitude flies in the face of almost 25 years of tax history. In the early 60's Congress enacted legislation creating section 274 of the Internal Revenue Code, a section aimed directly at business entertainment. That section had two principle goals:

1) To deny deductions based on estimations and uncorroborated statements of taxpayers; and

2) To deny deductions for items which are essentially social or living expenses.

Regulations were adopted by the IRS in response to that legislation. At that time, the Commissioner of the Internal Revenue Service commented on how the regulations were drafted:

> "In preparing regulations under the new statute, Internal Revenue did not work in an ivory tower.
>
> In the first instance, we meticulously sought to follow the direction of Congress. This was emphasized to our staff members who were charged with the responsibility of drafting the various provisions of the regulations...
>
> Next, our policy guideline was clearly fixed so as to apply a rule or reason and to attain a balanced set of regulations. We did not want the statute or regulations to interfere with legitimate business activity. Our aim was only to end abuses identified by the Congress. Both, during and after the drafting state, we conferred with many business and professional leaders to get their ideas and suggestions, and to work together with them in solving various practical problems. In addition, numerous business expense account forms and practices were carefully studied.
>
> Tentative regulations were then reviewed by my advisory group of outstanding lawyers, accountants and businessmen. Finally, the public comments were invited and public hearings were scheduled to obtain taxpayer reactions."

It seems clear from this language that the IRS was well aware of the goal to separate out any abusive, overly personal, part that may exist in some entertainment expenses while not impeding the flow of commerce. It is a fair inference that the IRS assumed there would be case by case decisions made within the framework of the statute and regulations using the existing audit procedure of the IRS and the tax court network when the audit procedure failed to resolve differences of opinion.

Furthermore, it may be inferred from the above quote that any arbitrary cap applied across the board, no matter how generous in the eyes of some, would "interfere with legitimate business activity." An arbitrary limit was not the solution then and is not the solution now. Better control of taxpayers who may abuse entertainment expense deductibility through proper audit procedure was and still is the correct method of handling this area.

Business is as opposed to abuse as the Administration although this fact may seem lost on our government officials. Those who file expense account forms for business expenses find personal entertainment desires insufficient justification for a company's auditing department.

The weakness of the Administation's argument can be found in the lengths they go to support these changes. After conceding that "such abuses may be limited to a relatively small number of taxpayers" they state that "they nevertheless undermine the public trust that is essential in a tax system based on self assessment." This concern for the public trust is found again when the document states that "despite its small revenue effect, the proposal (to eliminate or limit business deductions) would be of significant assistance in restoring trust in the tax system."

It is hard to believe that a change to curb limited abuses which raises virtually no revenue will be a trust builder in the eyes of the American public. Especially when these changes will cause major disruptions to the lodging and foodservice industry and force it to lay off many of its employees.

It is ironic that the most persuasive summary statement on the effectiveness of the current law and the disastrous impact of a curtailment of these legitimate deductions was made by the very man who now has set his seal of approval on these changes.

In a letter to the American Hotel & Motel Association dated October 18, 1980, then candidate, and now President, Ronald Reagan wrote:

> "The tax law already disallows tax deductions for personal-type expenses as opposed to business expenses. The business meal, business travel, etc. are an essential part of competitive business in the United States. The tourism industry, especially in its hotels, motels and restaurants, is one of the country's largest employers. A curtailment of tax deductions for business meals and travel would put thousands of people out of work, and hurt every aspect of tourism - both big business and small. I believe that present law properly enforced can encourage business opportunities and restrict abuses."

The President's complete letter is included as an appendix to this testimony.

We too believe, with this statement of the President, that nothing good can come from these changes and that the current law contains the proper balance of freedom to business and control to the government.

JOBS

When a vital part of the service sector of the economy is attacked, particularly the labor intensive lodging and foodservice sector, inevitably the loss must be measured in human terms, in those who must give up their jobs involuntarily.

The food and beverage area of hotel and motel operations generates over $11 billion of the $33 billion total revenue of the industry. In addition, business generates two-thirds of total revenues in the lodging industry. In many locations it is much higher, ranging in excess of 80 percent for facilities which specialize in fulfilling the convention and business meetings needs of America's workforce. An informal survey by our Association of such facilities has been uniform in the results obtained. It shows that any tax proposal which restricts entertainment expense deductions would have a very serious impact on those properties which are most dependent on convention and business meetings. Many of these properties are the major employers in their communities.

We must all question whether the pursuit of fairness and simplicity should be sought at the cost of tens of thousands of jobs in our industry alone and even greater unemployment when all industries are considered together. What good are lower tax rates to those who lose their jobs as a result of tax reform?

The Hotel Employees and Restaurant Employees International Union testified before the House Ways and Means Committee that a study commissioned by them showed that the business meal cap proposal currently in the President's tax package will cause a job loss of between 50,000 to 80,000. It seems clear that a significant portion of these 80,000 jobs will be lost in that foodservice segment of the lodging industry. Elimination of all entertainment deductions, if applied to the convention and banquet elements of our industry, could substantially increase those unemployment figures.

Even more important than the total number of jobs which will be lost from these proposals is the people who will lose their jobs. The lodging industry is one of the major employers of people in entry level positions which require little or no previous skill or experience. In addition, the lodging industry has created in excess of 20,000 jobs annually in the past few years. For some these jobs may prove to be starting points in a career; but for many of our service employees these jobs may represent their only means of gainful employment. If we take jobs away from these people they have little expectation of gaining other employment.

Revenue Impact

Reproduced below is that section of the President's proposal which indicates the change in receipts predicted for the business meal and entertainment revisions for the next five fiscal years, stated in billions of dollars.

	1986	1987	1988	1989	1990
Individual	.3	.6	.7	.8	.9
Corporate	.3	.6	.8	.9	1.0
Total	.6	1.2	1.5	1.7	1.9

These figures are stated with no supporting data to indicate how they were derived. This deprives us of the opportunity to challenge the process which led to these figures or to offer a different analysis.

It would seem to be a safe guess that the Administration has made the most favorable assumptions it could in deriving these revenue figures and yet it still has come up with exceedingly low amounts of revenue generated. Revenue amounts that are simply not worth the disruption which will be caused by these tax changes.

Also, it is safe to assume that the Administration has ignored the negative revenue impacts which will flow from these proposals. It is undeniable that many hotel/motel employees will lose their jobs as a result of this legislation. The first to be laid off will be those with the least chance of obtaining gainful employment rapidly. Tax dollars on their earnings will cease to flow into the Federal Treasury and at the same time expenditures for unemployment benefits and other forms of public assistance will increase. In light of the tiny revenue gain anticipated by the Administration, even a relatively minor disruption in employment levels for these service employees will quickly reduce real revenue gains to zero, or even to a negative figure, producing a net loss of revenue to the Treasury. In addition, state and local tax revenues will be diminished by a loss in lodging and foodservice sales.

Conclusion

In conclusion, we wish to state that the American Hotel & Motel Association is opposed to any changes in the treatment of entertainment and business meal expenses. If enacted, these changes will increase unemployment in our industry while returning little if any revenue to the Treasury. Instead, we call on this Committee to control any abuse which may exist by insisting on proper enforcement of the existing laws in this area.

STATEMENT OF MOON LANDRIEU, CHAIRMAN, MAINSTREETS COALITION, WASHINGTON, DC

Mr. **Landrieu**. Good morning, Senator. Thank you. My name is Moon Landrieu, and I represent the MainStreets Coalition, and I thank you for the opportunity to present a perhaps broader but no less important view with respect to the opposition to this particular provision. And Senator Long, I am very grateful for your presence, sir.

Senator **Long**. I would like very much to hear Secretary Landrieu's testimony.

Mr. **Landrieu**. I went into politics, Senator, in 1960 and have been working with cities since that time. I think many of us forget what happened to America's cities back then. Throughout the mid-1960's and early 1970's, many of the cities of America were burning; and they were burning because people were frustrated over many things—civil rights certainly, to be sure, but also because of jobs and frustration, and of the general decay that was taking place in America's cities. And it took place for a number of reasons, some of which were natural and some were inspired by Federal policy. From a natural standpoint, cities were outgrowing their boundaries, and industry was moving out into suburbia. Manufacturing, which once was in the center city, was now finding itself in cramped quarters and needing a new place to be more efficient. So, too, with wholesale functions and with warehouse functions. And as we suffered the great disinvestment in America's cities in the 1960's and 1970's, we wondered whether or not cities really had a role any longer in this country. Those of us who were then managing the cities refused to believe that America's cities did not have a future. We couldn't figure out an alternative, other than their existence. And so, we embarked upon a program of trying to convert negative policies into positive policies; and every President since that time—Presidents Kennedy, Johnson, Nixon, and Ford—with model cities and community developments and general revenue sharing and mass transit and every development action grant and historic credits gave the urban governments tools they needed to help rebuild the cities.

Another thing happened, and that is that, as those cities began to rebuild, the private sector began to have faith once again in the downtowns. And lo and behold, they replaced the smokestack industries with the entertainment industries. And today it is the single fastest growing industry in the cities of America. Whether you are in Pittsburgh or in Atlanta or in Seattle or in San Francisco or New Orleans or Chicago or New York, it makes no difference. Every city that I have visited in the past 8 weeks is either building or expanding its convention center, building or expanding its airport. There are new hotels being built, and new opera houses and symphony halls; or if not new, at least restored theaters and opera houses and symphony halls; all because they have come to recognize that no other place in this country can perform the kinds of services that the center city performs. And yet, when Treasury I was introduced, it was so wrong-headed that, if that provision had been enacted, placing a cap on all travel, business and otherwise, that I predict to you that not another major hotel would have been built in American cities. That is how wrong-headed that proposal was. This one is not much better.

It still attacks what today is the lifeblood of America's cities; and if it remains in the tax bill or if it is adopted, I predict to you, Senator, that not only will it have the impact the other gentlemen on this panel have said, but you are also going to see the bloom taken off of the new development and the rebirth in America's cities. It unfortunately comes at a time when, pressed with great deficits, Congress is looking at the reduction of general revenue sharing and the elimination of community development, the reduction of urban development action grants, and many other positive programs that gave this new development to America's cities. There may not be much that you can do about that. I know that you are wrestling with that, but surely it makes very little sense, at a time when cities now have perhaps the capability even without those programs to limp along. I am not so sure they will, but at least they have got a fighting chance—to drive the last stake by now putting them at an economic advantage and striking out at the one new industry that is giving them some vitality. I thank you, Senator. I will be happy to answer any questions.

The CHAIRMAN. Mr. Secretary, thank you.

[The prepared written testimony of Mr. Landrieu follows:]

STATEMENT ON TAX REFORM

UNITED STATES SENATE

COMMITTEE ON FINANCE

OCTOBER 4,1985

BY

MOON LANDRIEU
CHAIRMAN
THE MAINSTREETS COALITION

Mr. Chairman and members of the committee, let me, first of all, thank you for permitting me to testify here today on the subject of tax reform. Specifically, my testimony will relate to proposals that would limit or eliminate deductions for business meals and business entertainment.

As chairman of the MainStreets Coalition, I have spent the past two and a half months traveling around the country. I've visited nearly two dozen cities, as kind of a Paul Revere, meeting with a variety of local members of our coalition -- convention bureau chiefs, restaurant and hotel owners and workers, auditorium managers, community boosters, local citizens active in the arts and municipal officials. I've been alerting them about these proposals vis-a-vis business marketing entertainment that would, if enacted, impact negatively on our cities and on the institutions -- lyric operas, symphonies and sports teams -- that make them great.

The message I've received, out there in the grass roots -- the message that they asked me to bring back to you, here in Washington, was loud and clear: business entertainment is good for cities and good for business. Let's keep it that way.

Not so very long ago -- in the early seventies -- about the time I became mayor of New Orleans, center cities across the country were in a state of decline and decay. It seemed that just about everywhere you looked, plant gates were closing and assembly lines were shutting down. Most mayors were grappling with shrinking tax revenues and expanding unemployment. I can tell you, the outlook then wasn't too bright.

But city planners and business leaders in places like Minneapolis and St. Louis, Pittsburgh and New Orleans didn't quit. Instead, they mixed together roughly equal doses of imagination, innovation, federal and state assistance, and luck to come up with something called urban renewal.

Block by block, landmarks were reclaimed, older buildings were recycled and new buildings erected. In many cases, this renewal was anchored by the construction of new hotels and restaurants, clustered around centuries old landmarks such as Boston's Faneuil Hall, and more recently, the South Street Seaport on New York's waterfront, near the docks where Senator Moynihan once worked. The point is that it was the hospitality industry that emerged, in what many felt was the cities' darkest hour, to take up the economic slack from dying smokestack and heavy industries. This same industry is the one, which many now seek to penalize.

To illustrate this point more fully, just three weeks ago, at a MainStreets Coalition meeting I attended in Pittsburgh, Joe Kane, who runs the Hilton Hotel there pointed out that by 1990, the hospitality business will be the Steel City's number one industry.

In fact, hospitality -- the visitors industry -- is absolutely crucial today to most local economies. Just ask Stanley Hong, President of the Hawaii Visitors Bureau, who says that conventions mean $300 million a year to Hawaii's $4 billion tourist industry. Across the continent, in New York -- on Broadway, in Greenwich Village, along Central Park South, at Madison Square Garden and Yankee Stadium -- the industry is at least as crucial.

When I appeared with Mayor Andrew Young, in early September, in Atlanta, he was quick to point out that the visitors industry in Atlanta is formidable. "There are 188,916 jobs in Atlanta related to the convention and tourist industry," said Mayor Young. He added: "That represents nearly a $1 billion payroll in our city."

In Tulsa, Don Raulie, who runs that city's convention bureau told me:

> "$719 million is spent in Tulsa County each year by visitors and conventioneers. That translates into nearly $15 million in taxes for the state of Oklahoma and more than $11 million more in taxes for Tulsa County."

Though worded somewhat differently, the messages from Don DePorter and Arnie Morton in Chicago, Bill Giles and Tom Muldoon in Philadelphia, Greg Ortale in Houston, Terry Forsberg in Omaha and Hardy Smith down in Talladega, Alabama were much the same.

That is why I believe that this particular proposal is a blueprint for disaster. It will cut the heart out of this industry, put close to 600,000 people out of work nationwide, do enormous harm to cities, and intrude on the manner in which businessmen market their products and services.

But don't take my word alone on this. I refer you instead to people like Regina Dyton, Vice President of the Hartford (Connecticut) Urban League, who speaks eloquently on the need for entry level jobs in cities:

> "The restaurant, hotel and entertainment industry represents a great resource for the Urban League in terms of job development...As we talk about job development for poor people, there are thousands of people, within the city of Hartford, who at present, have very very low educational levels and limited skills. Entertainment and food industries are the places where people can start...Basic jobs where people can start will always be needed... Thriving businesses are necessary for that to happen."

Jack Walsh, Executive Director of the St. Louis Convention and Visitors Bureau adds:

> "It (changes in the tax code) would have a devastating impact in my opinion. I think it would cost St. Louis City and County a tremendous number of jobs in the entry level...The government would not think of taking the pipe wrench away from the plumber, but they are concerned about taking the business lunch or business dinner away from us as a selling tool."

Once again, on the question of jobs, Jim McCormick of Oakland, Secretary-Treasurer of Local Two of the Hotel Employees and Restaurant Employees Union, writes:

> "As a labor intensive business with strong reliance on those with...limited, entry level skills, any reduction in the work force hits restaurant workers especially hard because they are not easily re-employed in other industries."

Buttressing these arguments, from the grass roots, is a study from Chase Econometrics, the well-respected economic forecasting firm, conducted for the National Restaurant Association. According to Chase, business marketing meals, the type that would be capped under the proposal, account for over one-fifth of restaurant sales nationwide. If meal caps become a reality, Chase predicts that some 580,000 people across the country would lose their jobs. This is due to the greater elasticity of demand -- price sensitivity -- of the business meal. The Treasury Department's own Office of Tax Analysis has indicated that for every one percent increase in the price of business meals, spending declines two to four percent.

What's more, such a move would cost the deficit-ridden federal treasury $2.8 billion in its initial three years. This is attributable to decreases in personal income and social security tax receipts and an increase in transfer payments.

Over the same period, embattled state and local governments, fighting to stave off elimination of state and local tax deductibility, would fare poorly too. They'd lose $3.2 billion. This despite the Administration's pledge and the Ways & Means Committee's stated intention to seek "revenue neutrality" in tax reform.

So why do it? Why propose to end these deductions if the effort will add no revenue to the federal coffers, even as we face this seemingly insurmountable deficit problem. Well, my best guess is that it adds something of a populist tone to the overall tax reform package. I only wonder if we can afford this kind of shallow so-called populism if it costs this many jobs and forfeits so much urban progress.

Now since statistics tell only part of the story here, it would seem that a dose of good old-fashioned horse sense, from my old friend and your colleague on this panel, Senator Russell Long -- who I might add comes from a long tradition of populism -- is appropriate. Back in 1978, when the Carter Administration proposed to eliminate deductibility for business meals and entertainment, Senator Long observed that: "Entertainment is to sales what fertilizer is to agriculture. It increases the yield." That comment I think, underscores an important philosophical question at stake here. Shouldn't businesses be allowed to determine how best to market their products, without interference? President Reagan thinks so -- or used to.

In 1980, candidate Reagan wrote:

> "The business meal, business travel, etc. are an essential part of competitive business in the United States ... I believe that the present law, properly enforced, can encourage business opportunities and restrict abuses.

Merely 18 days ago, President Reagan, underscoring the vital role of vigorously expanding service industries, acknowledged, at his news conference, that while we have lost 1.6 million manufacturing jobs since 1979, "we've added 9 million new jobs in the travel and service industries."

Across America, people and organizations that recognize the impact of our tax laws on the continued viability of our cities, are joining us as members of the MainStreets Coalition. They are equally concerned about these fundamental changes in the way the tax code would treat business. They include: The American Society of Association Executives, The Convention Liaison Council, The Hotel & Restaurant Employee International Union, The International Association of Auditorium Managers, The International Association of Convention and Visitors Bureaus, The National Clubs Association, The National Motorsports Committee, The National Restaurant Association, Owned and Operated Holiday Inns, and The Washington Performing Arts Society.

My gut feeling, and the sentiment of MainStreets, is that the real issue here is, and has always been, jobs and economic development in cities.

Gentlemen of the Senate, I know that most of you here today are as concerned about the future of our cities -- our treasured public objects -- as am I. I ask only that you not act in haste, and that you look beyond superficialities.

As you deliberate, in the weeks ahead, over the shape and the thrust of tax reform, I hope that you will take the time, before you act, to consider long and hard how any new law will affect what is at present, the bright future of America's cities.

The CHAIRMAN. Gentlemen, as you are aware, so long as this is a representative form of government, by and large Congress will eventually reflect public opinion. It may lag a bit. I think our founders may have intended that; but if there is a perception in the public, and that perception rightly or wrongly exists for a long period of time, Congress will finally reflect that perception. Tell me, what do you say to the logger at a coffee shack who asks: How come those guys can buy a $100 meal and the Government picks up half the cost of it, when all I can do is take a half an hour for lunch and I can't deduct it? What answer do you give them?

Mr. FISHER. I think the answer that has to come forward, and you are really getting to the nub of the issue, I think, with the personal consumption aspect, is that there is business risk and there is personal effort involved. Any individual who puts capital at risk has the availability under current law to deduct his marketing expenses, and this is one avenue in which you can do it.

The CHAIRMAN. Let me slow you up again. Phrase the answer in language I should use with that logger.

Mr. FISHER. The answer is that——

The CHAIRMAN. So that the logger understands the answer.

Mr. FISHER. That the business tools that are available to the business person creates employment, and that the logger has his job because business is being generated throughout the country by using this mechanism.

The CHAIRMAN. And it can't be generated without the deduction of a $100 meal?

Mr. FISHER. Not to the same degree. The marketing meal is a valuable promotional tool. Without it, the business losses would be greater than the revenue gain that would come through taxes.

Mr. SALOMONE. If I may attempt to answer that question, Mr. Chairman, I am in the hotel business. I have lived in hotels, and I am in hotels every day; and I frequent the dining rooms of hotels. And I know the occupancy of hotels, that is, 22 percent in some cities is international travel. They are not all tourists. They are business people. And I sit in my hotel dining rooms and I watch a table of Japanese or Swiss or German businessmen—all selling the same product. They all are entertaining, and I do not think that our American Government can permit our business people to be handicapped and to be restricted to the equivalent of a ham sandwich while our competitor is selling the same product and creating jobs in his country, while those jobs are needed here; I think Senator Long put it well during the infamous "three-martini" battle, when he says the business meal is basically the same as fertilizer is to agriculture. It keeps it growing, and that is the whole idea of the business meal.

The **Chairman**. It increases business like fertilizer?

Mr. **Salomone**. Something like that, sir. [Laughter.]

But I am very serious about it. To me, it would send our business people into the world terribly handicapped, with one arm tied behind their back. I think that truck driver who complained at one time that he could not buy a ham sandwich while someone was dining in "21" ought to be thankful that that person is hustling day and night to create new industry and new jobs; and that is the crux of the whole problem. You are seriously going to handicap the American enterprise system. Now, there is certain abuse; and again, I repeat, if there is abuse, hire 10,000 more IRS agents and get them out there auditing. We would certainly welcome that.

The **Chairman**. Well, I am not sure you would. [Laughter.]

Mr. **Salomone**. Representative Rostenkowski said that years ago in the Ways and Means Committee, and I smiled back. And I said I am about half right, but that is the name of the game. The laws are there, and I think they should be enforced if there is abuse.

The **Chairman**. Again, I am interested with what the public perceives. When they see an expensive commercial on television, they are unaware of what it costs to produce that commercial. I have some sense of what they cost, having to have some produced in political campaigns. But the public when they see a beer ad or a really well done, tasteful ad, not many understand that millions go into the cost of production. So, when you use the argument that businesses advertise, the public cannot imagine that advertising is as costly as it is. So, whether a business chooses to pay $100,000 to produce an ad or $200,000 and produce an ad at a Cadillac price instead of a Chevrolet price—and I analogize that as a $20 dinner versus a $50 dinner—they don't see that difference. They do see the difference in the cost of a meal because all of us have paid for meals. It is not that I don't sympathize with you, but I don't find the answers you have given will wash with the general public. And eventually, if they don't wash, then these deductions will be gone. I wish I could give you a better answer, but I understand how eventually responsive we are to grassroots public opinion. Senator Long.

Senator **Long**. I would like to hear what Mayor Landrieu has to say.

Mr. **Landrieu**. Senator, I am not unmindful of how difficult it is to take this one provision and submit it to a public referendum, but certainly that would be true of most issues in the tax bill. Part of the reason for the reform is that it is complicated, and of course, the public at times misunderstands the nature of the provisions. You would have the same response from the public if you talked about oil and gas depletion allowances or certain other historic credits.

Senator **Long**. Capital gains for timber.

Mr. Landrieu. Capital gains for timber. [Laughter.]

Interest on homes. How do you explain to the renter that they perhaps, being in a lower economic class or of less income, do not get the interest deduction on their living quarters, as for those who are able to live in a $300,000 and $500,000 house? There are all kinds of problems within this tax garden, but when you start to hack at the weeds, let's understand how the garden grew. There is an economic symmetry out there. There is a competitive world in which we have to exist. And simply because there is at least a feeling against the three martini lunch, which has been lampooned and kind of popularized, this is seen as the way the businessman does business. There is no reason to hack away at what has been a legitimate time-honored business tool in a free society. There are many societies that wish that you didn't have a choice, that there is only one product; and therefore, we save all of the money that is spent in advertising. I watched the news on NBC last night, and they paid some $300 to $500 million to bring to America the Olympics—a nice price tag that might be saved if we weren't competing against one another, but the very nature of our economy is that we do have a free competitive system and we want competitive products. And conversely, given that as a basis, the businessman then competes for the business out there with the best tools that he has at hand. And to many people, the best tool they have is the eye-to-eye contact, the establishment of a relationship which can only be done on a person-to-person basis and not through the yellow pages or through national advertising on television. So, I agree with you that it is a difficult problem to answer, but that doesn't mean it is not a solid business approach.

Senator Long. For your information, the mail I have received on this subject is running 350 to 1 in your favor. That indicates that the people who understand the issue and are concerned about it are overwhelmingly for you. Legitimate entertaining is an expense of a salesman or someone who is trying to close a contract for his business. I don't think that it is fair to judge a legitimate expense item based on the opinion of somebody who doesn't know anything about it, who never had the problem, and who would insist that his own problem be given proper consideration. I have been voting on this matter for many years. I have found that the side with which I have been voting, which happens to be your side, has all the best politics with it. Of course, to ensure that you have the best politics, you have to remind the restaurant owners of what is at stake. Every time you go into a restaurant, remind the owner that somebody up here tried to say that you shouldn't be able to deduct the expense of entertaining in his restaurant. Some years back we did something under President Kennedy that adversely affected the restaurants.

Mr. Salomone. I believe they requested a receipt for anything over $25. That was in 1963, and it caused a wobble in the industry and layoffs.

Senator Long. It created a lot of unhappiness among people in the restaurant business and it hurt their business. Subsequent to that, we have had this matter up time and again. There is one point that hasn't been made here that I think ought to be considered. New Orleans is going to have restaurants—good restaurants—downtown. If some close, there will be others available, no matter what we do with this bill. However, there are many small towns and cities where the average middle income family can't afford to be a member of the country club. Suppose that family wanted to celebrate something—when grandma and grandpa have their 50th anniversary, a significant family event, entertaining the elder member of the family. They want to do something real nice. It is not deductible, and nobody claims it is or should be. But a nice restaurant in a nice community can't stay open without day-to-day business. If you are going to increase by 50 percent or double the expense of someone entertaining in restaurants, that is going to close a great number of them. There will be many little towns and small cities that don't have a nice place where you can take anybody. A nice restaurant is an important asset to a small community. You know so well yourself, Mr. Landrieu, from your experience in Louisiana and around the Nation that many small cities don't have more than one nice place to go. If they don't have some regular business—somebody who can deduct it as an entertainment expense—they can't keep their doors open.

Mr. LANDRIEU. Senator, you know, that is so true. All of us tend to look at things from a different perspective; and of course, I have been dealing with the major cities. Your story reminds me that when I was Secretary of HUD, we received an application from a small—a very small—town for a Dairy Queen. You know, we think in terms of hotels and convention centers and office buildings. So, I met with him, and I said you know it is highly unusual—a very small grant—I think it was $200,000 or something. He said: "Mr. Secretary, you couldn't do anything better for our town." He said: "Our kids have no place to go after hours, and that Dairy Queen will be the biggest and most important social gathering place in our town." And we did fund it, obviously, because it was important to that city. And I think you make a very valid point, even outside of the large cities. I have been fearful of what has happened, Mr. Chairman, to the downtowns of America's cities and we are just watching them come back now. To kill that off just out of a sense of mistaken popularity of some concept, I just think is dead wrong. I don't know that we can give you the best answer, but those are the best ones that I have.

Mr. SALOMONE. May I take you back just a little bit, too, on the dangers of what we are speaking about in respect to hotels and the effect on community; that is, Dairy Queen. There are many, many small towns throughout America whose one, single industry is a hotel. And I am not going to talk about the Greenbriers or the Homesteads or the French Licks or the rest of them, but if that hotel—and incidentally, of those hotels, we have determined that probably 87 percent of their total business comes out of the conventions, meetings, and conferences. So, if you dare tamper with that, you are going to close down many small towns across America; literally. I want to talk just a bit about a hotels sensitivity. Hotels are marginal to a great extent. We don't know and we can't tell you next week what the occupancy is going to be in most hotels in this country. We are not like an office building where they sign up a nice lease—10-year lease, 20-year lease. They escalate all your costs on through. When everybody goes home, the office building closes down at 5 p.m. Hotels of this Nation operate 7 days a week, 24 hours a day. They have to be there. The most perishable item in the world is a hotel room. If it is not sold tonight, it is never going to be sold, like an airline seat or like a restaurant seat if it is not used. So, you are putting us in jeopardy. And I will tell you exactly what is going to happen throughout this hotel industry. You are going to put a lot of them out of business because they are very marginal right now. In respect to restaurants, if you diminish the entertainment, the banqueting income of their hotels, you are going to even force these into bankruptcy. The industry will respond very quickly, and I am talking about restaurants in hotels and I am now talking about employment of people. We will very quickly start to close down our restaurants and try to lease them out to a bank or to some retail usage. So, this "reform" is going to have a tremendous effect across America and in the hotel industry. Now, if you affect the hotel occupancy in every city and in every county, you are going to affect the airlines flying in, the number of seats they sell. You are going to affect the taxi industry. You are going to affect the street vendors. You are going to affect the retail sales. So, it will ripple right on through. And I need not tell everyone here what tourism means and the fact that every city of America and every small town is now building a convention center in order to attract more conventions. So, you are at the threshold, if you are not careful, of destroying something that is great. I want to go just a little bit further, and I see the red light is on. America is losing its share of market; that is, in tourism. We now have gateway committees formed. All you have to do is check with the Commerce Department and the U.S. Travel and Tourism Administration because there are so many other viable places throughout the world to visit that America no longer has the monopoly it once had on tourism. Gentlemen, I thank you.

The CHAIRMAN. Gentlemen, no other questions. Thank you very much. Now, if we might move onto a panel of Louis Susman, Abe Pollin, Richard Dull, if he is here, and if not, Phillip Hochberg, Joseph Noll, and Lee Seidler. Gentlemen, go right ahead. I might say a word about Mr. Pollin. I am not even a resident of this town, but just as one who occasionally passes through here in my business occupation, let me say I very much appreciate what Mr. Pollin has done for this town. I think you have done it in a very gentlemanly and very honest fashion.

Mr. POLLIN. Thank you, Senator.

The CHAIRMAN. Mr. Susman.

STATEMENT OF LOUIS B. SUSMAN, GENERAL COUNSEL, ST. LOUIS CARDINALS, ST. LOUIS, MO; ON BEHALF OF MAJOR LEAGUE BASEBALL

Mr. SUSMAN. Thank you. Mr. Chairman, my name is Louis Susman. I am a member of the executive committee and general council of the St. Louis Baseball Cardinals, and I am appearing today on behalf of major league baseball. I don't know if I will be a better witness, but I am a happier witness today than I might have been yesterday. [Laughter.]

The CHAIRMAN. But you are not an absolutely secure witness yet.

Mr. SUSMAN. Very insecure. It is our understanding that the purpose of this proposed tax reform legislation is to create a fairer, a simpler, and a revenue neutral bill to benefit the American taxpayer. Mr. Chairman, this bill, major league baseball believes, the proposals that we have seen, does not meet the fairness test, is not simple, and becomes a revenue negative. In reverse order. According to studies—we all have studies—the Wharton School—all of sports of a professional nature, the four major sports, could lose in tax revenue for the Treasury $1.7 billion. In addition to that, if you include all the tickets that are bought at the University of Oregon, boosters for football games and basketball games and all the professional and amateur sports, it could be as high as $2.5 billion. I might add, and I think this is important, that the Treasury Department has stated that they might, and I am quoting, "be able to justify $300 million a year in additional revenue by the proposed change in all the business entertainment deductions." But they lack supporting data to sustain that. The difficulty in the simplicity of a government enforcing business judgments on what would be an appropriate form of business entertainment and recordkeeping that would be required isn't going to simplify the Tax Code, isn't going to simplify your tax return and my tax return, but complicate it. How are we going to divide the costs of that hot dog and that soda? That is what could be required. And last but not least is really the issue of fairness. In the event the deduction is eliminated, now Mr. Chairman, you and all Members of Congress should know, ticket prices will be increased and will become more expensive for the middle and lower income earner, as well as depriving corporations from using tickets for employees. And I know in my city many of those employees wait for that night that they might go because what will happen is that corporations will cut down on the number of tickets that they buy. Abuse. Are we abusive? Is this excess spending? I don't think so. Business purchases of baseball tickets are by no means excess businesses' spending and is mainly a commitment to support a valuable franchise of a community. My good friend, Senator Long, left here. I don't believe that they can literally get a baseball team in New Orleans without corporate business support in the buying of tickets, and what that means to every town, including Washington, DC. Mr. Chairman, the average ticket price is $6.67. We go from $1.50 up to $9.75. All I can say is that ticket prices will increase close to 38 percent; 43 percent of all baseball ticket sales, including 81 percent—81 percent—of season ticket sales, are bought by corporations. Increasing ticket prices will be inevitable, having the ironic impact of causing baseball to raise ticket prices for the family fan, the very person we are trying to help. Last but not least is the impact on cities and municipal authorities. It would be severe in that stadium rental, which is usually dependent upon attendance, would result in a shift of the cost of the tax base, penalizing the average taxpayer instead of the user. In conclusion, the way I see it—and Senator Long made an interesting point about the fact that those tickets which corporations are buying are subsidizing in many ways the lower priced ticket. As I said, in conclusion, we are not talking about yachts and eating caviar or abusive real estate shelters. We share no hue and cry from the blue-collar worker, the logger next door, saying gee whiz, Mr. Fat Cat sitting next to me at a ball game. It is going to be negative revenue. It is not going to be simple, and I guarantee you, it is not going to help the people that we perceive are crying out for help in tax reform. I am honored to be here. Thank you.

The CHAIRMAN. Thank you. Mr. Pollin, as I understand, you are representing basketball, hockey, and football today. Is that right?

Mr. POLLIN. Yes, sir.

[The prepared written statement of Mr. Susman follows:]

COMMITTEE ON FINANCE

UNITED STATES SENATE

WASHINGTON, D.C. 20515

LOUIS B. SUSMAN, ESQ.

ON BEHALF OF

MAJOR LEAGUE BASEBALL

OCTOBER 4, 1985

STATEMENT

OF MAJOR LEAGUE BASEBALL

October 4, 1985

Major League Baseball registers the strongest possible objection to the President's proposal to deny income tax deductions for the purchase by businesses of sports tickets. The proposal is advanced by the President on grounds of economic efficiency and tax equity. The facts and reasonable analysis demonstrate, however, that the purchase of tickets to baseball games by businesses serves legitimate business purposes and is not subject to tax law abuse. Moreover, elimination of the tax deduction would have devastating economic effects in Baseball; would not result in greater availability or lower ticket prices for non-business purchasers; would likely raise ticket prices for the family fan; and would have serious revenue consequences for cities and municipalities.

Effect of President's Proposal

In order to measure the impact of the President's proposal, we have surveyed each of our Major League Clubs. We have asked the accounting firm of Ernst & Whinney to compile the results and perform certain numerical and sensitivity analyses. Attached to this statement as Exhibit "A" is the Ernst & Whinney report, which in large measure serves as the basis for the arguments and conclusions set forth herein. The Ernst & Whinney report supports the following:

FIRST, business purchases of baseball tickets are by no means "excessive" business spending. The average ticket price paid by business purchasers in 1984, the last year for which we have final figures, was only about $6.67. Baseball tickets were available in 1984 in the United States at prices ranging from $1.50 to $9.00, and in 1985 from $1.50 to $9.75. Season tickets in 1984 averaged less than $500 and season tickets purchased by businesses about $540. It is clear that an expenditure for baseball tickets does not constitute an extravagant or unseemly business expense. Many businesses purchase tickets to sporting events because of their strong commitment of community support for their teams. Community support is something Major League Baseball very much wants to encourage. Tickets are used as incentives for employees and for business promotions or relations with customers. All of these are legitimate and fully appropriate business purposes.

SECOND, our Clubs estimate that over 19 million tickets were sold in 1984 to businesses. This constituted approximately 43% of all baseball ticket sales (including 81% of our season ticket sales) and 46% of total baseball ticket revenue. The President's proposal to deny business entertainment deductions would put in jeopardy the

$128 million in baseball ticket revenue and $48 million of concession revenue generated by businesses. This $176 million total equals nearly 30% of 1984 revenues. The average potential revenue loss per Club could equal as much as a staggering $6 million in an industry in which most Clubs already lose money and average only about $24 million in total revenue.

THIRD, Baseball Clubs cannot afford to lose all or even a portion of such substantial revenues and stay in business. Lost business season ticket sales would be very difficult to replace. In total, Baseball Clubs suffered losses of more than $28 million in 1984, and only six of the twenty-six Clubs had profits. Our projections through 1988 show ever increasing losses for Baseball despite significantly growing revenues. These projections of course assume that business purchases will continue unabated. If the President's proposal is enacted, the decrease in revenues from business purchases would likely turn each of our few profitable Clubs into a losing Club. Clubs presently losing money might find it impossible to operate.

FOURTH, Baseball Clubs have high fixed expenses and would be forced to attempt to recoup lost business ticket revenues in the form of increased ticket prices. If even a portion of business purchases were lost, Clubs would be forced to increase ticket prices to make up the margin. For example, the replacement of a 60% decrease in business ticket revenue requires a ticket price increase of approximately 37%. (See Table 4 of the Ernst & Whinney report attached hereto as Exhibit "A".) Thus, this proposal would have the ironic impact of forcing Baseball to significantly raise ticket prices for the family fan, although part of the rationale for the President's proposal is to bring greater equity to that fan. Baseball has taken pride in its efforts to keep our ticket prices such that every American family can enjoy a day at the ballpark. A change in the tax laws should not force us to change our pricing or place a greater financial burden on our fans.

FIFTH, the impact on cities and municipal authorities would be severe. Stadium rental is usually dependent upon attendance revenues. Concession and parking revenues retained by city authorities are also a direct function of attendance. Our Clubs estimate that 45% of the total ticket sales tax they collect is generated by business purchases. Moreover, if some of our Clubs are unable to survive the loss of revenues from business ticket purchases, municipally-owned stadiums could stand unused.

These facts lead us to the inescapable conclusion that the President's proposal to deny deductions for sports tickets should be rejected. Present law and IRS regulations provide adequate protection against excessive or unwarranted expenditures that are not properly deductible. The case cannot be made in either the name of efficiency or equity to deny business tax deductions for tickets to sports events.

Baseball Economics

It is beyond question that the President's proposal comes at a most critical time for Baseball. Financial operating results show that the industry faces serious economic difficulties. Our Clubs have suffered staggering economic losses that will only be compounded if the President's proposal is enacted. Attached to this statement as Exhibits "B" and "C" are summaries of Baseball's economic position. As shown, our current projections report losses from Baseball operations growing from $29 million in 1985 to $86 million by 1988.

An analysis of Baseball's finances also clearly demonstrates that attracting fans to the ballpark is crucial to the economic survival of the sport. While national and regional broadcast revenues account for a portion of each Club's income, the fan in the ballpark accounts for most of Baseball's total revenue. In 1984, approximately 54% of Baseball's total revenue came from ticket, concession and parking sales. While broadcast revenues are presently growing, it is by no means certain that they will be sustained at current levels, much less grow as we head into the 1990's. Thus, any proposal which would tend to lower ticket sales is a potential death blow to our industry.

A closer look at our attendance demonstrates that the President's concerns of efficiency and equity will not be improved by disallowing deductions for baseball tickets. First, baseball tickets are moderately priced. The Ernst & Whinney analysis shows that in 1984 the average business ticket purchaser paid approximately $6.67 per ticket or $540 for all 81 home games. That same business purchaser spent approximately $2.50 for parking and at concession stands while at the park. Thus, the average business consumer spends less than $10 per game for admission and concession purposes, an amount which is not extravagant. Moreover, prices at the ballpark are hardly conducive to the type of artificially high entertainment expenditures the President seeks to curtail. The primary bill of fare has been and will remain nothing more elegant than a hot dog and a cold drink.

Second, ticket prices are not going to decline if business purchases are no longer made. Indeed, the reverse is the more likely case. To start, as noted above, Baseball tickets are very moderately priced. Indeed, in 1985 the average ticket price is $6.21 and in most parks one can gain admission for $3.00 or less. Our prices are set well in advance of the season and once set are not changed. Consider also that notwithstanding record attendance years of late, Major League Baseball plays to only about 42% of total capacity. In 1984 Major League Baseball averaged about 22,050 in attendance per opening with an average seating capacity per park in excess of 52,000. Lastly, each Major League Baseball Club is faced with fixed costs totally unrelated to its patronage which will have to be met through existing sources of revenue. These factors -- low ticket prices, excess capacity and high fixed costs -- all point in the direction of higher ticket prices for remaining fans if any significant number of business patrons no longer buys baseball tickets.

Effects Beyond Baseball

Baseball's economic effects are felt far beyond the four corners of each Club's operating statement. Our Clubs employ thousands of citizens, pay taxes, attract visitors and otherwise make significant contributions to the social and economic fabric of the communities in which they play. Our analysis shows that over $11 million in sales taxes were paid to municipalities by virtue of our business customers in 1984. This badly needed source of revenue is seriously threatened by the President's proposal. Cities and states can ill afford to lose any of the direct or indirect financial benefits a solid Major League franchise brings.

Already, the United States Congress finds itself concerned with the relocation of sports franchises and the problems it perceives when sports teams move to new locales. Baseball is in favor of franchise stability but the enactment of the President's proposal could only aggravate our financial situation, putting additional pressure on Clubs to consider moves in order to provide for their economic survival. This is an additional burden Baseball Clubs and their cities should not have to suffer.

Conclusion

The President's proposal would have a disastrous effect on Major League Baseball. It would deny an otherwise appropriate business deduction for tickets to sports events and impose a severe economic burden not only on Major League Baseball but also on the communities in which we do business, with little correlative gains. We urge that the proposal be rejected.

EXHIBIT "A"

Ernst & Whinney

153 East 53rd Street
New York, New York 10022

212/888-9100

April 1, 1985

Mr. Peter V. Ueberroth
Commissioner of Baseball
350 Park Avenue
New York, NY 10022

Dear Commissioner Ueberroth:

We are pleased to present the results of our study evaluating the potential impact on the Major League Baseball clubs of the proposed elimination of the long-standing deduction for the business-related purchase of tickets to sporting events. The report is divided in sections as follows: scope of the study, approach, findings and an appendix ~~with~~ exhibits presenting the detail of data used in the analysis.

SCOPE OF OUR STUDY

The scope of our study included the following:

1. Compilation and analysis of the 1984 ticket sales information as provided by the responses to the questionnaire that the Office of the Commissioner of Major League Baseball (Baseball) sent to the 26 Major League clubs, and follow-up by telephone to individual clubs as required for clarification of responses.

2. Completion of a sensitivity analysis demonstrating the potential impact on ticket sales and ticket prices if all or a portion of Major League Baseball's business-related purchases were lost.

APPROACH

We compiled the responses to the questionnaire that was sent to the clubs in a computer model that was used to analyze the information. Once all information was entered on a consistent basis, we performed calculations with the computer model to demonstrate the impact on overall ticket receipts, ticket prices, concession and other non-ticket receipts, and sales tax receipts of losses of various levels of business ticket sales.

We compiled the results of these calculations in tables which show the ticket volume, price and revenue information by ticket type and total and concession and sales tax revenue information.

FINDINGS

Table 1 shows the total paid attendance for 1984 as provided by the 26 Major League clubs and a breakdown of season tickets, partial plan and single game tickets as estimated by the clubs.

Table 2 demonstrates that the great majority of season tickets -- approximately 81% -- are purchased for business purposes. These season tickets, by themselves, account for over one-fourth of Major League Baseball tickets sold.

In addition, clubs estimate that about 48% of all partial season tickets and 20% of single-game tickets are purchased for business purposes. Thus, as the table shows, approximately 43% of Major League ticket purchases could be affected by the Treasury Department's tax proposal.

Business purchasers account for an even larger share of revenues than the attendance figures would suggest because they tend to purchase slightly higher priced seats. As is shown in Table 3, the clubs estimate that the aggregate amount of ticket revenues from business purchasers was approximately $128,089,000 or about 46% of total purchases of $278,831,000 compared to the 43% of total number of tickets. 1/

Table 3 also shows that the clubs estimate that business purchases account for approximately 42 percent of revenues from concessions, programs, parking, and similar items. Although some clubs receive less than the entire amount of these revenues, the potential losses obviously would be substantial and would be suffered by a combination of the Baseball clubs and other private or municipal agencies. Similarly, the clubs estimate that 45% of total sales tax revenues from Baseball ticket sales are from business-related purchases.

Table 4 summarizes the impact of losses in business-related ticket volume of 60%, 80% and 100% on various categories compared to 1984 reported

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1/ Ticket receipts do not include charges for luxury or skyboxes, but do include normal admission charges for access to the boxes.

figures for those categories for the 24 U.S. clubs which would be subject to changes in federal tax regulations. For example, a decrease in 60% of ticket sales for business-related purposes in 1984 would have resulted in a 27% decrease in total ticket revenue for U.S. clubs from $259,637,000 to $188,887,000. Total loss of ticket sales for business purposes would have reduced total revenues for U.S. clubs to $141,720,000, a decrease of 45% in revenues.

Table 4 includes the average dollar amount per capita received by Baseball (i.e., exclusive of sales tax) for all tickets as reported for 1984 and the average per capita amount required for non-business tickets (exclusive of sales tax) in order to maintain total 1984 ticket revenues for the 24 U.S. clubs assuming various levels of lost business-related ticket purchases. For example, a 100% drop in business-related purchases would have required the average 1984 per capita ticket amount without tax to rise from $6.33 to $11.08 to compensate for the loss. In reality, the amount would have to increase more because some volume of non-business-related purchases would be lost as a result of price increases. Moreover, the average ticket amount for non-business-related purchasers as reported for U.S. clubs was $6.05--or 28 cents lower than the average including business-related purchases--thus adding to the amount of the price increase required to compensate for lost business-related revenues.

To summarize, the study that we performed indicates that the elimination of a federal income tax deduction for the business-related purchase of tickets to sporting events could have a substantial negative impact on Baseball's ticket revenues. Business-related purchases account for 46% of Baseball's ticket revenues and over 80% of all season tickets purchased. The extent of the impact on total ticket revenues is, of course, dependent upon the amount of business-related ticket purchases lost and the sensitivity of the non-business-related customers to any changes in ticket prices caused by lost revenues. The magnitude of the potential harmful effects could be very significant.

Very truly yours,

Ernst + Whinney

TABLE 1

MAJOR LEAGUE BASEBALL

TOTAL TICKETS BY CLUB AND CATEGORY

1984 SEASON (1)

Club	Total Paid Attendance(2)	Season Tickets(3) Number	Season Tickets(3) % of Total Attendance	Partial-Plan Tickets(3) Number	Partial-Plan Tickets(3) % of Total Attendance	Single Game Tickets(4) Number	Single Game Tickets(4) % of Total Attendance
1. Atlanta	1,724,892	370,656	21.5%	77,536	4.5%	1,276,700	74.0%
2. Chicago (NL)	2,104,219	181,440	8.6%	149,296	7.1%	1,773,483	84.3
3. Cincinnati	1,275,887	777,834	61.0	14,184	1.1	483,869	37.9
4. Houston	1,229,862	675,945	55.0	136,464	11.1	417,453	33.9
5. Los Angeles	3,134,824	2,162,700	69.0	0	N/A	972,124	31.0
6. Montreal (U.S. $) (5)	1,606,531	910,359	56.7	56,000	3.5	640,172	39.8
7. New York (NL)	1,842,695	447,440	24.3	92,696	5.0	1,302,559	70.7
8. Philadelphia	2,062,693	635,120	30.8	800,255	38.8	627,318	30.4
9. Pittsburgh	773,500	316,872	41.0	79,075	10.2	377,553	48.8
10. St. Louis	2,037,448	699,672	34.3	34,512	1.7	1,303,264	64.0
11. San Diego	1,983,904	272,640	13.7	482,070	24.3	1,229,194	62.0
12. San Francisco	1,001,545	195,156	19.5	276,861	27.6	529,528	52.9
13. Baltimore	2,045,784	654,320	32.0	276,324	13.5	1,115,140	54.5
14. Boston	1,661,618	401,000	24.1	375,000	22.6	885,618	53.3
15. California	2,402,997	1,400,247	58.3	20,800	0.9	981,950	40.9
16. Chicago (AL)	2,136,988	665,000	31.1	285,000	13.3	1,186,988	55.5
17. Cleveland	734,079	124,394	16.9	20,100	2.7	589,585	80.3
18. Detroit	2,704,794	341,926	12.6	77,112	2.9	2,285,756	84.5
19. Kansas City	1,810,018	950,000	52.5	0	N/A	860,018	47.5
20. Milwaukee	1,608,509	435,200	27.1	41,268	2.6	1,132,041	70.4
21. Minnesota	1,598,422	180,954	11.3	25,256	1.6	1,392,212	87.1
22. New York (AL)	1,821,815	732,159	40.2	233,252	12.8	856,404	47.0
23. Oakland	1,353,281	224,880	16.6	102,263	7.6	1,026,138	75.8
24. Seattle	870,372	205,092	23.6	4,160	0.5	661,120	76.0
25. Texas	1,102,471	454,329	41.2	1,250	0.1	646,892	58.7
26. Toronto (U.S. $) (5)	2,110,009	728,000	34.5	0	N/A	1,382,009	65.5
TOTAL ALL CLUBS	44,739,157	15,143,333	33.8%	3,660,734	8.2%	25,935,090	58.0%

(1)--Tables 1 through 3 include the totals for the two Canadian clubs in order to reflect totals for all of Major League Baseball. However, the analysis summarized in Table 4 includes only the 24 U.S. clubs under the assumption that the Canadian clubs would not be affected by the proposed change in U.S. tax regulations.

(2)--From records supplied by Office of the Commissioner.

(3)--As Reported by Major League clubs in response to questionnaire distributed by Office of the Commissioner. In some cases, Partial-Plan Tickets were estimated based on an average number of games under the plans provided by the clubs.

(4)--Single game ticket totals were provided by clubs. In cases where the sum of season tickets plus partial game tickets plus single game tickets was greater than total paid attendance, single game tickets were reduced under the assumption that single game tickets as reported included unpaid attendees while season and partial plan tickets were paid.

(5)--Conversion rate, Canadian $ to U.S. $ = 0.775 based on average for 1984 season provided by Office of the Commissioner.

TABLE 2

MAJOR LEAGUE BASEBALL

BUSINESS PORTION OF NUMBER OF TICKETS

1984 SEASON (1)

Club	Total Business-Related Tickets(2)		Business-Related Season Tickets(2)		Business-Related Part. Plan Tickets(2)		Business-Related Single Game Ticket(2)	
	Number	% of Total Attendance	Number	% of Total Season Tickets	Number	% of Total Part. Plan	Number	% of Total Single Game
1. Atlanta	589,167	34.2%	295,164	79.6%	41,216	53.2%	252,787	19.8%
2. Chicago (NL)	429,330	20.4	145,800	80.4	45,808	30.7	237,722	13.4
3. Cincinnati	687,856	53.9	598,932	77.0	10,921	77.0	78,003	16.1
4. Houston	677,745	55.1	569,106	84.2	52,624	38.6	56,015	13.4
5. Los Angeles	1,620,833	51.7	1,506,600	69.7	0	N/A	114,233	11.8
6. Montreal (U.S. $) (3)	854,043	53.2	668,250	73.4	20,800	37.1	164,993	25.8
7. New York (NL)	772,396	61.9	420,960	94.1	47,275	51.0	304,161	23.4
8. Philadelphia	1,268,666	61.5	598,640	94.3	533,353	66.6	136,673	21.8
9. Pittsburgh	401,629	51.9	269,568	85.1	56,550	71.5	75,511	20.0
10. St. Louis	981,883	48.7	665,000	95.0	17,000	49.3	299,883	23.0
11. San Diego	452,960	22.8	216,240	79.3	175,260	36.4	61,460	5.0
12. San Francisco	297,645	29.7	193,647	99.2	77,522	28.0	26,476	5.0
13. Baltimore	826,489	40.4	463,120	70.8	63,369	22.9	300,000	26.9
14. Boston	974,324	58.6	290,000	72.3	225,000	60.0	459,324	51.9
15. California	1,334,156	55.5	1,120,230	80.0	19,500	93.8	194,426	19.8
16. Chicago (AL)	881,205	41.7	465,000	69.9	70,000	24.6	346,205	29.2
17. Cleveland	325,934	44.4	116,030	93.3	17,040	84.8	192,864	32.7
18. Detroit	707,703	26.2	293,740	85.9	68,985	89.5	344,978	15.1
19. Kansas City	794,506	43.9	700,000	73.7	0	N/A	94,506	11.0
20. Milwaukee	573,835	35.7	391,680	90.0	21,266	51.5	160,889	14.2
21. Minnesota	723,481	45.3	170,100	94.0	12,580	49.8	540,801	38.8
22. New York (AL)	891,673	48.9	702,837	96.0	140,877	60.4	47,959	5.6
23. Oakland	431,302	31.9	193,225	85.9	52,132	51.0	185,945	18.1
24. Seattle	270,110	31.0	155,925	76.0	3,200	76.9	110,985	16.8
25. Texas	682,357	61.9	431,649	95.0	750	60.0	249,958	38.6
26. Toronto (U.S. $) (3)	1,066,003	50.5	656,000	90.1	0	N/A	410,003	29.7
TOTAL ALL CLUBS	19,199,856	42.9%	12,297,443	81.2%	1,773,028	68.4%	5,129,385	19.8%

(1)--Tables 1 through 3 include the totals for the two Canadian clubs in order to reflect totals for all of Major League Baseball. However, the analysis summarized in Table 4 includes only the 24 U.S. clubs under the assumption that the Canadian clubs would not be affected by the proposed change in U.S. tax regulations.

(2)--Estimates provided by the Major League clubs.

(3)--Conversion rate, Canadian $ U.S. $ = 0.775 based on average for 1984 season provided by Office of the Commissioner.

TABLE 3

MAJOR LEAGUE BASEBALL

BUSINESS PORTION OF TICKET REVENUES, CONCESSION AND SALES TAX RECEIPTS

1984 SEASON (1)

(000's)

Club	Total Ticket Receipts(2)	Business-Related Ticket Receipts(3) $	Business-Related Ticket Receipts(3) % of Total Receipts	Concessions and Other Nonticket Receipts(4)	Business-Related Concessions and Other 3) $	Business-Related Concessions and Other 3) % of Total Concession and Other	Total Sales Tax Receipts(4)	Business-Related Sales Tax Receipts(3) $	Business-Related Sales Tax Receipts(3) % of Total Sales Tax
1. Atlanta	$ 11,478	$ 5,291	46.1%	$ 8,934	$ 3,538	39.6%	$ 1,266	$ 553	43.7%
2. Chicago (NL)	11,870	3,030	25.5	3,800	1,021	26.9	1,436	373	26.0
3. Cincinnati	9,537	4,424	46.4	1,353	634	46.9	1,144	536	46.9
4. Houston	9,829	5,631	57.3	1,028	621	60.4	66	40	60.1
5. Los Angeles	20,310	9,500	46.8	17,550	7,050	40.2	1,150	460	40.0
6. Montreal (U.S. $) (5)	9,618	4,351	45.2	5,787	1,269	21.9	1,375	562	40.9
7. New York (NL)	12,009	4,804	40.0	3,858	1,543	40.0	1,909	764	40.0
8. Philadelphia	15,357	10,017	65.2	6,404	3,714	58.0	2,399	1,515	63.1
9. Pittsburgh	6,129	2,826	46.1	885	360	40.7	611	260	42.6
10. St. Louis	13,690	6,160	45.0	9,918	4,463	45.0	1,975	889	45.0
11. San Diego	12,009	3,213	26.8	2,328	512	22.0	412	89	21.5
12. San Francisco	7,749	2,015	26.0	1,720	447	26.0	335	87	26.0
13. Baltimore	11,422	5,358	46.9	4,043	1,819	45.0	915	412	45.0
14. Boston	11,083	4,767	43.0	3,340	2,200	65.9	340	150	44.1
15. California	13,956	7,825	56.1	10,500	4,950	47.1	600	275	45.8
16. Chicago (AL)	12,948	5,840	45.1	4,480	2,000	44.6	1,350	625	46.3
17. Cleveland	4,422	1,948	44.0	546	240	44.0	133	58	43.7
18. Detroit	16,312	5,000	30.7	4,556	1,190	26.2		N/A	
19. Kansas City	10,178	5,275	51.8	4,680	2,080	44.4	1,775	1,000	56.3
20. Milwaukee	10,233	4,109	40.1	6,565	2,357	35.9	824	317	38.5
21. Minnesota	8,521	3,747	44.0	2,344	1,102	47.0	1,603	705	44.0
22. New York (AL)	12,201	8,205	67.2	2,500	1,100	44.0	1,647	860	52.2
23. Oakland	6,953	2,491	35.8	2,131	767	36.0	189	68	36.0
24. Seattle	4,562	1,442	31.6	716	222	31.0	332	103	31.0
25. Texas	6,879	5,000	72.7	3,811	2,363	62.0	187	125	67.0
26. Toronto (U.S. $) (5)	9,577	5,822	60.8	1,008	620	61.5	1,457	667	45.7
TOTAL ALL CLUBS	$278,831	$128,089	45.9%	$114,776	$48,181	42.0%	$25,430	$11,492	45.2%

(1)--Tables 1 through 3 include the totals for the two Canadian clubs in order to reflect totals for all of Major League Baseball. However, the analysis summarized in Table 4 includes only the 24 U.S. clubs under the assumption that the Canadian clubs would not be affected by the proposed change in U.S. tax regulations.

(2)--Total ticket receipts are as provided by the Major League clubs net of state and municipal sales and use taxes.

(3)--Estimated by Major League clubs.

(4)--From records of Major League clubs.

(5)--Conversion rate, Canadian $ U.S. $ = 0.775 based on average for 1984 as provided by Office of the Commissioner.

TABLE 4

MAJOR LEAGUE BASEBALL

IMPACT OF VARIOUS LEVELS OF
LOST BUSINESS-RELATED SALES

1984 SEASON (1)

	As Reported for 1984		% of Business-Related Sales Lost (U.S. Club Only)		
	All 26 Clubs	U.S. Clubs Only	60%	80%	100%
Total Ticket Revenue (000's $) (2)	278,831	259,637	188,887	165,303	141,720
Ticket Revenue--Business-Related (000's $) (3)	128,089	117,916	47,166	23,583	-0-
Ticket Revenue--Business-Related (% of Total Ticket Revenue) (3)	45.9%	45.4%	25.0%	14.3%	-0-
Average Ticket Price Required for Total Ticket Revenue to Remain Constant	$6.23 (4)	$6.33 (4)	$8.52 (5)	$9.66 (5)	$11.08 (5)
Total Concession Revenue (000's $) (6)	114,776	107,982	80,206	70,948	61,689
Concession and Other Revenue--Business-Related (000's $) (3)	48,181	46,293	18,517	9,259	-0-
Concession and Other Revenue--Business-Related (% of Total Concession and Other) (3)	42.0%	42.9%	23.1%	13.0%	-0-
Total Sales Tax Revenue (000's $) (6)	25,430	22,598	16,439	14,387	12,336
Sales Tax Revenue--Business-Related (000's $) (3)	11,492	10,264	4,106	2,053	-0-
Sales Tax Revenue-Business-Related (% of Total Sales Tax Revenue) (3)	45.2%	45.4%	25.0%	14.3%	-0-

(1)--Tables 1 through 3 include the totals for the two Canadian clubs in order to reflect totals for all of Major League Baseball. However, the analysis summarized in Table 4 includes only the 24 U.S. clubs under the assumption that the Canadian clubs would not be affected by the proposed change in U.S. tax regulations.

(2)--As reported by Major League clubs net of state and local sales and use taxes.

(3)--Based on estimates provided by the Major League clubs.

(4)--Per capita amount for 1984 calculated as total 1984 ticket revenues divided by total paid attendance.

(5)--Per capita amount required of non-business purchasers to compensate for loss of business-related purchases.

(6)--As reported by Major League clubs.

APPENDIX

BASEBALL COMMISSION
TICKET SALES ANALYSIS

EXHIBIT A

NO LOSS OF BUSINESS-RELATED PURCHASES

CLUB	SEASON TICKETS			PARTIAL PLAN TICKETS			SINGLE GAME TICKETS			TOTALS		
	SEASON TICKETS-BUSINESS	TOTAL SEASON TICKETS	% BUSINESS OF SEASON TICKETS	PARTIAL PLAN-1984 BUSINESS	TOTAL PARTIAL PLAN-1984	% BUSINESS OF PARTIAL PLAN	SINGLE GAME-BUSINESS	TOTAL SINGLE GAME	% BUSINESS OF SINGLE GAME	TOTAL TICKETS-BUSINESS	1984 TOTAL TICKETS	% BUSINESS OF TOTAL TICKETS
1. ATLANTA	295,164	370,636	79.6%	41,216	77,336	53.3%	252,787	1,276,700	19.8%	589,167	1,724,672	34.2%
2. CHICAGO (NL)	145,800	181,440	80.4%	45,808	149,276	30.7%	237,722	1,773,483	13.4%	429,330	2,104,199	20.4%
3. CINCINNATI	598,932	777,830	77.0%	10,921	14,188	77.0%	78,003	483,869	16.1%	687,856	1,275,887	53.9%
4. HOUSTON	569,106	675,945	84.2%	52,624	136,464	38.6%	56,015	417,453	13.4%	677,745	1,229,862	55.1%
5. LOS ANGELES	1,506,600	2,162,700	69.7%	0	0	NA	114,233	972,124	11.8%	1,620,833	3,134,824	51.7%
6. MONTREAL (U.S. $) (1)	668,250	910,359	73.4%	20,800	56,000	37.1%	164,993	640,172	25.8%	854,043	1,606,531	53.2%
7. NEW YORK (NL)	420,960	447,440	94.1%	47,275	92,696	51.0%	304,161	1,302,559	23.4%	772,396	1,842,695	41.9%
8. PHILADELPHIA	598,640	635,120	94.3%	533,353	800,255	66.6%	136,673	627,318	21.8%	1,268,666	2,062,693	61.5%
9. PITTSBURGH	269,568	316,872	85.1%	56,530	79,473	71.1%	75,531	377,381	20.0%	401,629	773,726	51.9%
10. ST. LOUIS	665,000	699,672	95.0%	17,000	34,312	49.5%	299,083	1,303,264	23.0%	981,083	2,037,248	48.2%
11. SAN DIEGO	216,240	272,640	79.3%	175,260	482,070	36.4%	61,460	1,229,194	5.0%	452,960	1,983,904	22.8%
12. SAN FRANCISCO	193,647	195,156	99.2%	77,322	376,061	20.6%	26,476	529,328	5.0%	297,445	1,100,545	27.0%
13. BALTIMORE	463,120	654,320	70.8%	63,369	276,324	22.9%	300,000	1,115,140	26.9%	826,489	2,045,784	40.4%
14. BOSTON	290,000	401,000	72.3%	225,000	375,000	60.0%	459,324	885,618	51.9%	974,324	1,661,618	58.6%
15. CALIFORNIA	1,120,230	1,400,297	80.0%	19,500	20,800	93.8%	194,426	981,900	19.8%	1,334,156	2,402,997	55.5%
16. CHICAGO (AL)	465,000	665,000	69.9%	70,000	285,000	24.6%	346,205	1,186,100	29.2%	881,205	2,136,100	41.3%
17. CLEVELAND	116,030	124,394	93.3%	17,040	20,100	84.8%	192,866	589,585	32.7%	325,936	734,079	44.4%
18. DETROIT	293,740	341,920	85.9%	68,985	77,112	89.5%	344,978	2,285,758	15.1%	707,703	2,704,790	26.2%
19. KANSAS CITY	700,000	950,000	73.7%	0	0	NA	94,506	860,048	11.0%	794,506	1,810,048	43.9%
20. MILWAUKEE	391,680	435,200	90.0%	21,266	41,268	51.5%	160,889	1,132,041	14.2%	573,835	1,608,509	35.7%
21. MINNESOTA	170,100	180,954	94.0%	12,580	25,256	49.8%	540,801	1,392,212	38.8%	723,481	1,598,422	45.3%
22. NEW YORK (AL)	702,837	732,159	96.0%	140,877	233,252	60.4%	47,959	856,404	5.6%	891,673	1,821,815	48.9%
23. OAKLAND	193,225	224,888	85.9%	52,132	102,203	51.0%	185,945	1,026,130	18.1%	431,302	1,353,221	31.9%
24. SEATTLE	155,925	205,092	76.0%	3,200	4,160	76.9%	110,985	661,120	16.8%	270,110	870,372	31.0%
25. TEXAS	621,649	654,329	95.0%	750	1,250	60.0%	249,938	646,892	38.6%	872,337	1,302,471	67.0%
26. TORONTO (U.S. $) (1)	656,000	728,000	90.1%	0	0	NA	410,003	1,382,009	29.7%	1,066,003	2,110,009	50.5%
TOTAL ALL CLUBS	12,297,443	15,143,333	81.2%	1,773,020	3,660,734	48.4%	5,129,385	25,935,890	19.8%	19,199,848	44,739,957	42.9%
TOTAL U.S. CLUBS	10,973,193	13,504,970	81.3%	1,752,220	3,604,734	48.6%	4,871,744	23,912,909	20.4%	17,597,157	41,022,613	42.9%

(1) Conversion rate, Canadian $ to U.S. $ = 0.775 based on average for 1984 season provided by Office of the Commissioner.

BASEBALL COMMISSION
TICKET SALES ANALYSIS

EXHIBIT A

NO LOSS OF BUSINESS-RELATED PURCHASES

CLUB	TICKETS			TICKET RECEIPTS							CONCESS. RECEIPTS	
	TOTAL TICKETS MINUS X% OF BUSINESS(2)	TOTAL BUS. TICKETS MINUS X % (2)	% BUSINESS OF TOTAL AFTER X% DECR(2)	TOTAL BUSINESS RECEIPTS (1)	TOTAL TICKET RECEIPTS(3)	% BUSINESS OF TOTAL RECEIPTS	TOTAL TICKETS MINUS X% OF BUSINESS(2)	TOTAL BUS. RECEIPTS MINUS X %(2)	% BUSINESS OF TOTAL AFTER X% DECR (2)	% REV. LOST FROM X% BUS. LOST(2)	CONCESS., NON-TICKET-BUSINESS	CONCESS., NON-TICKET-TOTAL
1. ATLANTA	1,724,092	389,167	30.2%	$5,291,487	$11,478,280	46.1%	$11,478,280	$5,291,487	46.1%	0.0%	$3,337,864	$8,934,000
2. CHICAGO (NL)	2,104,219	429,330	20.4%	3,029,865	11,870,000	25.5%	11,870,000	3,029,865	25.5%	0.0%	1,021,000	3,000,000
3. CINCINNATI	1,275,887	687,856	53.9%	4,424,082	9,536,826	46.4%	9,536,826	4,424,082	46.4%	0.0%	634,356	1,352,571
4. HOUSTON	1,229,962	677,745	55.1%	5,631,070	9,829,490	57.3%	9,829,490	5,631,070	57.3%	0.0%	620,500	1,027,530
5. LOS ANGELES	3,134,024	1,620,833	51.7%	9,500,000	20,310,000	46.8%	20,310,000	9,500,000	46.8%	0.0%	7,050,000	17,550,000
6. MONTREAL (U.S. $) (1)	1,606,531	854,043	53.2%	4,350,855	9,617,600	45.2%	9,617,600	4,350,855	45.2%	0.0%	1,260,675	5,786,925
7. NEW YORK (NL)	1,842,695	772,396	41.9%	4,803,695	12,009,230	40.0%	12,009,230	4,803,695	40.0%	0.0%	1,503,000	3,857,626
8. PHILADELPHIA	2,062,693	1,268,666	64.5%	10,016,904	15,356,948	65.2%	15,356,948	10,016,904	65.2%	0.0%	3,714,355	6,404,061
9. PITTSBURGH	773,500	401,629	51.9%	2,825,506	6,129,153	46.1%	6,129,153	2,825,506	46.1%	0.0%	360,000	885,000
10. ST. LOUIS	2,037,400	981,003	48.2%	6,160,000	13,689,543	45.0%	13,689,543	6,160,000	45.0%	0.0%	4,463,000	9,918,000
11. SAN DIEGO	1,983,904	452,960	22.8%	3,212,884	12,008,883	26.8%	12,008,883	3,212,884	26.8%	0.0%	512,216	2,328,253
12. SAN FRANCISCO	1,001,545	297,645	29.7%	2,014,697	7,748,836	26.0%	7,748,836	2,014,697	26.0%	0.0%	447,155	1,719,830
13. BALTIMORE	2,045,784	876,089	40.4%	5,357,628	11,421,520	46.9%	11,421,520	5,357,628	46.9%	0.0%	1,019,000	4,043,000
14. BOSTON	1,661,610	974,324	58.6%	4,767,000	11,083,082	43.0%	11,083,082	4,767,000	43.0%	0.0%	2,200,000	3,340,000
15. CALIFORNIA	2,402,997	1,334,156	55.5%	7,825,000	13,956,228	56.1%	13,956,228	7,825,000	56.1%	0.0%	4,950,000	10,500,000
16. CHICAGO (AL)	2,136,980	881,205	41.2%	5,839,976	12,947,797	45.1%	12,947,797	5,839,976	45.1%	0.0%	2,000,000	4,480,000
17. CLEVELAND	734,079	325,934	44.4%	1,947,757	4,422,030	44.0%	4,422,030	1,947,757	44.0%	0.0%	240,000	546,000
18. DETROIT	2,704,794	707,703	26.2%	5,008,429	16,312,334	30.7%	16,312,334	5,008,429	30.7%	0.0%	1,199,200	4,550,000
19. KANSAS CITY	1,810,018	794,506	43.9%	5,275,000	10,177,003	51.8%	10,177,003	5,275,000	51.8%	0.0%	2,000,000	4,600,000
20. MILWAUKEE	1,600,509	573,835	35.7%	4,108,571	10,233,197	40.1%	10,233,197	4,108,571	40.1%	0.0%	2,357,000	6,564,600
21. MINNESOTA	1,598,422	723,481	45.3%	3,747,203	8,520,600	44.0%	8,520,600	3,747,203	44.0%	0.0%	1,101,570	2,344,476
22. NEW YORK (AL)	1,821,815	891,673	48.9%	8,204,529	12,201,209	67.2%	12,201,209	8,204,529	67.2%	0.0%	1,100,000	2,500,000
23. OAKLAND	1,353,201	431,302	31.9%	2,490,555	6,953,064	35.8%	6,953,064	2,490,555	35.8%	0.0%	767,056	2,130,711
24. SEATTLE	870,372	270,110	31.0%	1,442,416	4,561,572	31.6%	4,561,572	1,442,416	31.6%	0.0%	221,816	715,537
25. TEXAS	1,102,471	682,357	61.9%	5,000,030	6,878,763	72.7%	6,878,703	5,000,000	72.7%	0.0%	2,362,561	3,810,583
26. TORONTO (U.S. $) (1)	2,110,009	1,066,003	50.5%	5,821,824	9,576,728	60.8%	9,576,728	5,821,824	60.8%	0.0%	620,000	1,007,500
TOTAL ALL CLUBS	44,739,157	19,199,856	42.9%	$120,008,942	$270,830,912	45.9%	$270,830,912	$120,008,942	45.9%	0.0%	$40,181,494	$116,776,203
TOTAL U.S. CLUBS	41,022,617	17,597,185	42.9%	$117,916,262	$259,636,504	45.4%	$259,636,504	$117,916,262	45.4%	0.0%	$46,292,729	$107,981,778

(1) Conversion rate, Canadian $ to U.S. $ = 0.775 based on average for 1984 season provided by Office of the Commissioner.

(2) X% = the percentage of business-related purchases assumed lost.

(3) Ticket revenue totals do not include charges for luxury boxes such as skyboxes, but do include normal admission charges for access to such boxes.

BASEBALL COMMISSION
TICKET SALES ANALYSIS

EXHIBIT A

NO LOSS OF BUSINESS-RELATED PURCHASES

CLUB	CONCESSION RECEIPTS						SALES TAX RECEIPTS					
	% BUSINESS OF TOTAL CONCESSIONS	TOTAL CONCESS. MINUS X% OF BUSINESS (2)	TOTAL BUS. CONCESS. MINUS X %(2)	% BUSINESS OF TOTAL AFTER X% DECR(2)	% CONC. LOST FROM X% BUS. LOST (2)	RENT,ETC. PAID TO MGMT.	SALES TAXES FROM BUSINESS	TOTAL SALES TAX	% BUSINESS OF TOTAL SALES TAX	TOT. SALES TAX MINUS X% OF BUSINESS(2)	TOTAL BUS. SALES TAX MINUS X %(2)	% BUSINESS OF TOTAL AFTER X% DECR (2)
1. ATLANTA	39.6%	$8,934,000	$3,537,864	39.6%	0.0%	$2,114,000	$553,242	$1,266,000	43.7%	$1,266,000	$553,242	43.7%
2. CHICAGO (NL)	26.9%	3,800,000	1,021,000	26.9%	0.0%	169,968	372,900	1,435,600	26.0%	1,435,600	372,900	26.0%
3. CINCINNATI	46.9%	1,352,571	634,356	46.9%	0.0%	1,248,000	336,410	1,143,733	46.9%	1,143,733	336,410	46.9%
4. HOUSTON	60.4%	1,027,530	620,500	60.4%	0.0%	693,704	39,606	65,942	60.1%	65,942	39,606	60.1%
5. LOS ANGELES	40.2%	17,550,000	7,050,000	40.2%	0.0%	0	460,000	1,150,000	40.0%	1,150,000	460,000	40.0%
6. MONTREAL (U.S. $) (1)	21.9%	5,786,925	1,268,675	21.9%	0.0%	1,798,000	564,875	1,374,955	40.9%	1,374,955	561,875	40.9%
7. NEW YORK (NL)	40.0%	3,857,626	1,543,000	40.0%	0.0%	1,021,310	763,500	1,908,726	40.0%	1,908,726	763,500	40.0%
8. PHILADELPHIA	58.0%	6,404,061	3,714,355	58.0%	0.0%	5,085,000	1,514,734	2,399,000	63.1%	2,399,000	1,514,734	63.1%
9. PITTSBURGH	40.7%	885,000	360,000	40.7%	0.0%	858,448	260,270	611,261	42.6%	611,261	260,270	42.6%
10. ST. LOUIS	45.0%	9,918,000	4,463,000	45.0%	0.0%	0	889,000	1,975,000	45.0%	1,975,000	889,000	45.0%
11. SAN DIEGO	22.0%	2,328,253	512,216	22.0%	0.0%	988,837	88,540	412,454	21.5%	412,454	88,540	21.5%
12. SAN FRANCISCO	26.0%	1,719,830	447,155	26.0%	0.0%	424,961	87,195	335,366	26.0%	335,366	87,195	26.0%
13. BALTIMORE	45.0%	4,043,000	1,819,000	45.0%	0.0%	1,000,000	411,832	915,183	45.0%	915,183	411,832	45.0%
14. BOSTON	65.9%	3,340,000	2,200,000	65.9%	0.0%	402,000	150,000	340,000	44.1%	340,000	150,000	44.1%
15. CALIFORNIA	47.1%	10,500,000	4,950,000	47.1%	0.0%	4,900,000	275,000	600,000	45.8%	600,000	275,000	45.8%
16. CHICAGO (AL)	44.6%	4,480,000	2,000,000	44.6%	0.0%	350,000	625,000	1,350,000	46.3%	1,350,000	625,000	46.3%
17. CLEVELAND	44.0%	546,000	240,000	44.0%	0.0%	0	58,000	132,661	43.7%	132,661	58,000	43.7%
18. DETROIT	26.2%	4,550,000	1,193,200	26.2%	0.0%	150,000	0	0	NA	0	0	NA
19. KANSAS CITY	44.4%	4,600,000	2,000,000	44.4%	0.0%	1,150,000	1,000,000	1,775,000	56.3%	1,775,000	1,000,000	56.3%
20. MILWAUKEE	35.9%	6,564,600	2,357,000	35.9%	0.0%	1,645,000	317,200	824,000	38.5%	824,000	317,200	38.5%
21. MINNESOTA	47.0%	2,344,476	1,101,570	47.0%	0.0%	673,478	705,456	1,603,309	44.0%	1,603,309	705,456	44.0%
22. NEW YORK (AL)	44.0%	2,500,000	1,100,000	44.0%	0.0%	1,200,000	860,000	1,647,000	52.2%	1,647,000	860,000	52.2%
23. OAKLAND	36.0%	2,130,711	767,056	36.0%	0.0%	1,863,936	68,050	189,029	36.0%	189,029	68,050	36.0%
24. SEATTLE	31.0%	715,537	221,816	31.0%	0.0%	802,342	102,802	331,610	31.0%	331,610	102,802	31.0%
25. TEXAS	62.0%	3,810,583	2,362,561	62.0%	0.0%	1,000,000	125,297	187,011	67.0%	187,011	125,297	67.0%
26. TORONTO (U.S. $) (1)	61.5%	1,007,500	620,000	61.5%	0.0%	1,162,500	666,500	1,457,000	45.7%	1,457,000	666,500	45.7%
TOTAL ALL CLUBS	42.0%	$114,776,203	$48,181,400	42.0%	0.0%	$30,502,356	$11,492,410	$25,429,848	45.2%	$25,429,848	$11,492,410	45.2%
TOTAL U.S. CLUBS	42.9%	$107,981,778	$46,292,729	42.9%	0.0%	$27,541,856	$10,264,035	$22,597,893	45.4%	$22,597,893	$10,264,035	45.4%

(1) Conversion rate, Canadian $ to U.S. $ = 0.775 based on average for 1984 season provided by Office of the Commissioner.

(2) X% = the percentage of business-related purchases assumed lost.

BASEBALL COMMISSION
TICKET SALES ANALYSIS

EXHIBIT A

0% LOSS OF BUSINESS-RELATED PURCHASES

CLUB	% TAX LOST FROM XX BUS. LOST(2)	PER CAPITA TICKET AMOUNTS PER CAPITA TICKET AMOUNT	AVERAGE NON BUSINESS TKT AMOUNT	AVERAGE TKT AMOUNT BUSINESS	AVERAGE TKT AMOUNT MINUS X %(2)	ADJ AVG TKT AMOUNT MINUS X %(2)
1. ATLANTA	0.0%	$6.65	$5.45	$8.90	$6.65	$6.65
2. CHICAGO (NL)	0.0%	5.64	5.20	7.06	5.64	5.64
3. CINCINNATI	0.0%	7.47	8.69	6.43	7.47	7.47
4. HOUSTON	0.0%	7.99	7.60	8.31	7.99	7.99
5. LOS ANGELES	0.0%	6.40	7.10	5.86	6.40	6.40
6. MONTREAL (U.S. $) (1)	0.0%	5.99	7.00	5.09	5.99	5.99
7. NEW YORK (NL)	0.0%	6.52	6.73	6.27	6.52	6.52
8. PHILADELPHIA	0.0%	7.45	6.75	7.90	7.45	7.45
9. PITTSBURGH	0.0%	7.92	8.00	7.86	7.92	7.92
10. ST. LOUIS	0.0%	6.72	7.13	6.27	6.72	6.72
11. SAN DIEGO	0.0%	6.05	5.75	7.09	6.05	6.05
12. SAN FRANCISCO	0.0%	7.70	8.15	6.77	7.70	7.70
13. BALTIMORE	0.0%	5.50	4.97	6.40	5.50	5.50
14. BOSTON	0.0%	6.67	9.19	4.89	6.67	6.67
15. CALIFORNIA	0.0%	5.81	5.74	5.87	5.81	5.81
16. CHICAGO (AL)	0.0%	6.06	5.66	6.63	6.06	6.06
17. CLEVELAND	0.0%	6.02	6.06	5.98	6.02	6.02
18. DETROIT	NA	6.03	5.66	7.07	6.03	6.03
19. KANSAS CITY	0.0%	5.67	4.83	6.64	5.67	5.67
20. MILWAUKEE	0.0%	6.36	5.92	7.16	6.36	6.36
21. MINNESOTA	0.0%	5.33	5.46	5.10	5.33	5.33
22. NEW YORK (AL)	0.0%	6.70	4.30	9.20	6.70	6.70
23. OAKLAND	0.0%	5.14	4.84	5.49	5.14	5.14
24. SEATTLE	0.0%	5.20	5.20	5.36	5.20	5.20
25. TEXAS	0.0%	6.24	4.47	7.33	6.24	6.24
26. TORONTO (U.S. $) (1)	0.0%	4.54	3.60	5.46	4.54	4.54
TOTAL ALL CLUBS	0.0%	$6.23	$5.70	$6.67	$6.23	$6.23
TOTAL U.S. CLUBS	0.0%	$6.33	$6.05	$6.70	$6.33	$6.33

(1) Conversion rate, Canadian $ to U.S. $ = 0.775 based on average for 1986 season, provided by Office of the Commissioner.

(2) X% = the percentage of business-related purchases lost.

BASEBALL COMMISSION
TICKET SALES ANALYSIS

EXHIBIT A

NO LOSS OF BUSINESS-RELATED PURCHASES

CLUB	CONCESSION EMPLOYEES(4)				USHERS (4)				CLEANING & STADIUM EMPLOYEES (4)			
	MIN.	MAX.	AVE.	AFTER DEDN.	MIN.	MAX.	AVE.	AFTER DEDN.	MIN.	MAX.	AVE.	AFTER DEDN.
1. ATLANTA	400	700	550	550	275	400	338	338	25	55	40	40
2. CHICAGO (NL)	120	420	270	270	100	240	170	170	55	65	60	60
3. CINCINNATI	147	500	324	324	90	179	135	135	104	185	145	145
4. HOUSTON	254	433	344	344	152	280	216	216	131	157	144	144
5. LOS ANGELES	300	400	350	350	275	315	295	295	75	100	88	88
6. MONTREAL	300	800	550	550	115	231	173	173	42	72	57	57
7. NEW YORK (NL)	400	500	450	450	120	220	170	170	75	100	88	88
8. PHILADELPHIA	100	250	175	175	230	320	275	275	60	100	80	80
9. PITTSBURGH	95	510	303	303	200	300	250	250	40	105	73	73
10. ST. LOUIS	250	310	280	280	170	270	220	220	43	88	66	66
11. SAN DIEGO	100	700	400	400	150	170	160	160	30	70	50	50
12. SAN FRANCISCO	120	500	310	310	59	230	145	145	32	92	62	62
13. BALTIMORE	250	500	375	375	75	220	148	148	40	110	75	75
14. BOSTON	200	300	250	250	90	175	100	100	70	90	80	80
15. CALIFORNIA	300	700	500	500	150	250	200	200	150	200	175	175
16. CHICAGO (AL)	60	350	205	205	95	250	173	173	30	100	65	65
17. CLEVELAND	245	765	505	505	60	160	110	110	230	325	278	278
18. DETROIT	350	620	485	485	120	180	150	150	60	85	73	73
19. KANSAS CITY	400	500	450	450	90	135	113	113	80	100	90	90
20. MILWAUKEE			0	0			0	0			0	0
21. MINNESOTA	120	650	385	385	105	250	178	178	100	200	150	150
22. NEW YORK (AL)	175	725	450	450	100	250	175	175	100	150	125	125
23. OAKLAND	40	77	59	59	95	155	125	125	8	12	10	10
24. SEATTLE	147	454	301	301	113	212	163	163	24	73	49	49
25. TEXAS	310	400	355	355	40	60	50	50	30	60	45	45
26. TORONTO	200	500	350	350	80	130	105	105	40	70	55	55
TOTAL ALL CLUBS	5,383	12,564	8,976	8,976	3,149	5,532	4,341	4,341	1,674	2,764	2,219	2,219
TOTAL U.S. CLUBS	4,883	11,264	8,076	8,076	2,954	5,171	4,063	4,063	1,592	2,622	2,107	2,107

(4) The numbers of employees required are included as reported by the individual Major League Baseball clubs for the 1984 season. The values are not varied for the sensitivity analyses.

BASEBALL COMMISSION
TICKET SALES ANALYSIS

EXHIBIT A

NO LOSS OF BUSINESS-RELATED PURCHASES

CLUB	SECURITY GUARDS (4) MIN.	MAX.	AVE.	AFTER DECR.	PARKING ATTENDANTS (4) MIN.	MAX.	AVE.	AFTER DECR.	ADMINISTRATIVE (4) MIN.	MAX.	AVG.	AFTER DECR.
1. ATLANTA	25	50	38	38	40	50	45	45	3	6	5	5
2. CHICAGO (NL)	40	75	58	58	5	7	6	6	5	5	5	5
3. CINCINNATI	29	49	39	39	50	50	50	50	57	57	57	57
4. HOUSTON	40	85	63	63	59	109	84	84	56	64	60	60
5. LOS ANGELES	90	115	103	103	40	50	45	45	20	20	20	20
6. MONTREAL	20	30	25	25	14	23	19	19	66	72	69	69
7. NEW YORK (NL)	80	150	115	115	12	15	14	14	15	25	20	20
8. PHILADELPHIA	70	100	85	85	30	60	45	45	65	75	70	70
9. PITTSBURGH	24	45	35	35	4	8	6	6	6	14	10	10
10. ST. LOUIS	92	123	108	108	43	43	43	43	20	20	20	20
11. SAN DIEGO	40	60	50	50	20	60	40	40	60	70	65	65
12. SAN FRANCISCO	32	75	54	54	0	0	0	0	25	30	28	28
13. BALTIMORE	45	80	63	63	45	60	53	53	10	15	13	13
14. BOSTON	35	60	48	48	5	8	7	7	16	20	18	18
15. CALIFORNIA	25	50	38	38	40	60	50	50	15	25	20	20
16. CHICAGO (AL)	35	170	103	103	25	90	58	58	35	50	43	43
17. CLEVELAND	40	60	50	50	20	30	25	25	15	20	18	18
18. DETROIT	50	75	63	63	0	0	0	0	20	30	25	25
19. KANSAS CITY	40	60	50	50	40	60	50	50	10	10	10	10
20. MILWAUKEE			0	0			0	0			0	0
21. MINNESOTA	6	15	11	11	0	0	0	0	30	60	45	45
22. NEW YORK (AL)	65	200	133	133	0	0	0	0	30	80	55	55
23. OAKLAND	50	84	67	67	10	20	23	23	50	75	63	63
24. SEATTLE	19	38	29	29	20	30	25	25	35	35	35	35
25. TEXAS	20	45	33	33	35	70	53	53	47	47	47	47
26. TORONTO	65	100	83	83	0	0	0	0	10	10	10	10
TOTAL ALL CLUBS	1,077	1,994	1,536	1,536	565	911	730	730	721	935	828	828
TOTAL U.S. CLUBS	992	1,864	1,428	1,428	551	880	720	720	645	853	749	749

(4) The numbers of employees required are included as reported by the individual Major League Baseball clubs for the 1984 season. The values are not varied for the sensitivity analyses.

BASEBALL COMMISSION
TICKET SALES ANALYSIS

EXHIBIT A

NO LOSS OF BUSINESS RELATED PURCHASES

CLUB	MISCELLANEOUS (4)				TOTAL (4)			
	MIN.	MAX.	AVE.	AFTER DECR.	MIN.	MAX.	AVE.	AFTER DECR.
1. ATLANTA	30	45	38	38	798	1,306	1,052	1,052
2. CHICAGO (NL)	10	15	13	13	335	827	581	581
3. CINCINNATI	37	45	41	41	514	1,065	790	790
4. HOUSTON	54	78	66	66	746	1,206	976	976
5. LOS ANGELES	40	50	45	45	840	1,050	945	945
6. MONTREAL	14	25	20	20	571	1,251	912	912
7. NEW YORK (NL)	10	15	13	13	712	1,025	869	869
8. PHILADELPHIA	90	115	103	103	645	1,020	833	833
9. PITTSBURGH	6	8	7	7	375	990	683	683
10. ST. LOUIS	72	92	82	82	690	946	818	818
11. SAN DIEGO	0	0	0	0	400	1,130	765	765
12. SAN FRANCISCO	2	5	4	4	270	932	601	601
13. BALTIMORE	0	0	0	0	465	985	725	725
14. BOSTON	44	47	46	46	460	630	545	545
15. CALIFORNIA	10	25	18	18	690	1,310	1,000	1,000
16. CHICAGO (AL)	0	0	0	0	280	1,010	645	645
17. CLEVELAND	5	15	10	10	615	1,375	995	995
18. DETROIT	15	25	20	20	615	1,015	815	815
19. KANSAS CITY	0	0	0	0	660	865	763	763
20. MILWAUKEE			0	0	0	0	0	0
21. MINNESOTA	10	20	15	15	371	1,195	783	783
22. NEW YORK (AL)	25	35	30	30	495	1,440	968	968
23. OAKLAND	0	0	0	0	261	431	346	346
24. SEATTLE	3	3	3	3	364	843	603	603
25. TEXAS	73	85	79	79	515	767	641	641
26. TORONTO	5	5	5	5	400	815	608	608
TOTAL ALL CLUBS	555	753	654	654	13,124	25,453	19,289	19,289
TOTAL U.S. CLUBS	536	723	630	630	12,153	23,387	17,769	17,769

(4) The numbers of employees required are included as reported by the individual Major League Baseball clubs for the 1984 season. The values are not varied for the sensitivity analyses.

BASEBALL COMMISSION
TICKET SALES ANALYSIS

EXHIBIT B

LOSS OF 60% OF BUSINESS-RELATED PURCHASES

CLUB	SEASON TICKETS			PARTIAL PLAN TICKETS			SINGLE GAME TICKETS			TOTALS		
	SEASON TICKETS-BUSINESS	TOTAL SEASON TICKETS	% BUSINESS OF SEASON TICKETS	PARTIAL PLAN 1984 BUSINESS	TOTAL PARTIAL PLAN 1984	% BUSINESS OF PARTIAL PLAN	SINGLE GAME-BUSINESS	TOTAL SINGLE GAME	% BUSINESS OF SINGLE GAME	TOTAL TICKETS-BUSINESS	1984 TOTAL TICKETS	% BUSINESS OF TOTAL TICKETS
1. ATLANTA	295,164	370,656	79.6%	41,216	77,536	53.2%	252,787	1,276,700	19.8%	589,167	1,724,892	34.2%
2. CHICAGO (NL)	145,800	181,440	80.4%	45,800	149,296	30.7%	237,730	1,773,483	13.4%	429,330	2,104,219	20.4%
3. CINCINNATI	598,932	777,836	77.0%	10,921	14,184	77.0%	78,003	483,869	16.1%	687,856	1,275,889	53.9%
4. HOUSTON	569,106	675,945	84.2%	52,624	136,464	38.6%	56,015	417,453	13.4%	677,745	1,229,862	55.1%
5. LOS ANGELES	1,506,600	2,162,700	69.7%	0	0	NA	114,233	972,129	11.8%	1,620,833	3,134,829	51.7%
6. MONTREAL (U.S. $) (1)	668,250	910,359	73.4%	20,800	56,000	37.1%	164,993	640,172	25.8%	854,043	1,606,531	53.2%
7. NEW YORK (NL)	420,960	447,440	94.1%	47,275	92,696	51.0%	304,161	1,302,559	23.4%	772,396	1,842,695	41.9%
8. PHILADELPHIA	598,640	635,120	94.3%	533,353	800,255	66.6%	136,673	627,318	21.8%	1,268,666	2,062,693	61.5%
9. PITTSBURGH	269,568	316,872	85.1%	56,550	79,075	71.5%	75,511	377,553	20.0%	401,629	773,500	51.9%
10. ST. LOUIS	665,000	699,672	95.0%	17,000	34,512	49.3%	299,883	1,303,264	23.0%	981,883	2,037,448	48.2%
11. SAN DIEGO	216,240	272,640	79.3%	175,260	482,070	36.4%	61,460	1,229,194	5.0%	452,960	1,983,904	22.8%
12. SAN FRANCISCO	193,647	195,156	99.2%	77,522	276,861	28.0%	26,476	529,528	5.0%	297,645	1,001,545	29.7%
13. BALTIMORE	463,120	654,320	70.8%	63,369	276,324	22.9%	300,000	1,115,140	26.9%	826,489	2,045,784	40.4%
14. BOSTON	290,000	401,000	72.3%	225,000	375,000	60.0%	459,324	885,618	51.9%	974,324	1,661,618	58.6%
15. CALIFORNIA	1,120,230	1,400,247	80.0%	19,500	20,800	93.8%	194,426	981,950	19.8%	1,334,156	2,402,997	55.5%
16. CHICAGO (AL)	465,000	665,000	69.9%	70,000	285,000	24.6%	346,205	1,186,900	29.2%	881,205	2,136,900	41.2%
17. CLEVELAND	116,030	124,394	93.3%	17,040	20,100	84.8%	192,864	589,585	32.7%	325,934	734,079	44.4%
18. DETROIT	293,740	341,924	85.9%	68,985	77,112	89.5%	344,978	2,285,758	15.1%	707,703	2,704,794	26.2%
19. KANSAS CITY	700,000	950,000	73.7%	0	0	NA	94,566	860,010	11.0%	794,566	1,810,010	43.9%
20. MILWAUKEE	391,680	435,200	90.0%	21,266	41,268	51.5%	160,889	1,132,041	14.2%	573,835	1,608,509	35.7%
21. MINNESOTA	170,100	180,954	94.0%	12,580	25,256	49.8%	540,801	1,392,212	38.8%	723,481	1,598,422	45.3%
22. NEW YORK (AL)	702,837	732,159	96.0%	140,877	233,252	60.4%	47,959	856,404	5.6%	891,673	1,821,815	48.9%
23. OAKLAND	193,225	225,000	85.9%	52,132	102,263	51.0%	185,945	1,026,138	18.1%	431,302	1,353,401	31.9%
24. SEATTLE	155,925	205,092	76.0%	3,200	4,160	76.9%	110,985	661,120	16.8%	270,110	870,372	31.0%
25. TEXAS	431,649	454,329	95.0%	750	1,250	60.0%	249,958	646,092	38.6%	682,357	1,101,671	61.9%
26. TORONTO (U.S. $) (1)	656,000	728,000	90.1%	0	0	NA	410,003	1,382,009	29.7%	1,066,003	2,110,009	50.5%
TOTAL ALL CLUBS	12,297,443	15,143,333	81.2%	1,773,020	3,660,734	48.4%	5,129,385	25,935,090	19.8%	19,199,856	44,739,157	42.9%
TOTAL U.S. CLUBS	10,973,193	13,504,974	81.3%	1,752,220	3,604,734	48.6%	4,871,764	23,912,909	20.4%	17,597,185	41,022,617	42.9%

(1) Conversion rate, Canadian $ to U.S. $ = 0.775 based on average for 1984 season provided by Office of the Commissioner.

BASEBALL COMMISSION
TICKET SALES ANALYSIS

EXHIBIT B

LOSS OF 60% OF BUSINESS-RELATED PURCHASES

CLUB	TICKETS					TICKET RECEIPTS					CONCESS. RECEIPTS	
	TOTAL TICKETS MINUS X% OF BUSINESS(2)	TOTAL BUS. TICKETS MINUS X %(2)	% BUSINESS OF TOTAL AFTER X% DECR (2)	TOTAL BUSINESS RECEIPTS (3)	TOTAL TICKET RECEIPTS (3)	% BUSINESS OF TOTAL RECEIPTS	TOTAL TICKETS MINUS X% OF BUSINESS(2)	TOTAL BUS. RECEIPTS MINUS X %(2)	% BUSINESS OF TOT. AFTER X% DECR (2)	% REV. LOST FROM X% BUS. DECR.(2)	CONCESS., NON-TICKET BUSINESS	CONCESS., NON TICKET TOTAL
1. ATLANTA	1,371,392	235,667	17.2%	$5,291,487	$11,478,200	46.1%	$8,303,308	$2,116,595	25.5%	27.7%	$3,537,864	$8,934,000
2. CHICAGO (NL)	1,046,621	171,732	9.3%	3,029,865	11,870,000	25.5%	10,052,081	1,211,946	12.1%	15.3%	1,021,000	3,000,000
3. CINCINNATI	863,173	275,102	31.9%	4,424,082	9,536,826	46.4%	6,882,377	1,769,633	25.7%	27.8%	634,356	1,352,571
4. HOUSTON	823,215	271,090	32.9%	5,631,078	9,829,490	57.3%	6,450,843	2,252,431	34.9%	34.4%	620,500	1,027,550
5. LOS ANGELES	2,162,324	648,333	30.0%	9,500,000	20,310,000	46.8%	14,610,000	3,800,000	26.0%	28.1%	7,050,000	17,550,000
6. MONTREAL (U.S. $) (1)	1,094,105	341,617	31.2%	4,350,855	9,617,600	45.2%	9,617,600	4,350,855	45.2%	0.0%	1,268,675	5,786,925
7. NEW YORK (NL)	1,379,257	308,950	22.4%	4,803,695	12,009,738	40.0%	9,127,521	1,921,478	21.1%	24.0%	1,543,000	3,857,626
8. PHILADELPHIA	1,301,493	507,466	39.0%	10,016,904	15,356,948	65.2%	9,346,806	4,006,762	42.9%	39.1%	3,714,355	6,404,061
9. PITTSBURGH	532,523	160,651	30.2%	2,825,506	6,129,153	46.1%	4,433,849	1,130,202	25.5%	27.7%	360,000	885,000
10. ST. LOUIS	1,448,318	392,753	27.1%	6,160,000	13,689,543	45.0%	9,993,543	2,464,000	24.7%	27.0%	4,463,000	9,910,000
11. SAN DIEGO	1,712,120	181,184	10.6%	3,212,884	12,008,883	26.8%	10,081,153	1,285,154	12.7%	16.1%	512,216	2,320,253
12. SAN FRANCISCO	827,958	119,058	14.5%	2,014,697	7,748,836	26.0%	6,540,018	805,879	12.3%	15.6%	447,155	1,719,830
13. BALTIMORE	1,549,891	330,596	21.3%	5,357,628	11,421,520	46.9%	8,206,943	2,143,051	26.1%	28.1%	1,019,000	4,043,000
14. BOSTON	1,077,024	389,730	36.2%	4,767,000	11,083,082	43.0%	8,222,882	1,906,800	23.2%	25.8%	2,200,000	3,340,000
15. CALIFORNIA	1,602,503	533,662	33.3%	7,825,000	13,956,228	56.1%	9,261,228	3,130,000	33.8%	33.6%	4,950,000	10,500,000
16. CHICAGO (AL)	1,608,265	352,482	21.9%	5,839,976	12,947,797	45.1%	9,443,811	2,335,990	24.7%	27.1%	2,000,000	4,400,000
17. CLEVELAND	538,518	130,374	24.2%	1,947,757	4,422,030	44.0%	3,253,376	779,103	23.9%	26.4%	240,000	546,000
18. DETROIT	2,200,172	283,001	12.9%	5,000,429	16,312,330	30.7%	13,312,077	2,000,172	15.0%	18.4%	1,190,200	4,550,000
19. KANSAS CITY	1,333,315	317,802	23.8%	5,275,000	10,177,083	51.8%	7,012,083	2,110,000	30.1%	31.1%	2,000,000	4,680,000
20. MILWAUKEE	1,264,208	229,534	18.2%	4,108,571	10,233,197	40.1%	7,768,054	1,643,428	21.2%	24.1%	2,357,000	6,564,600
21. MINNESOTA	1,164,333	289,393	24.9%	3,747,203	8,520,680	44.0%	6,272,358	1,498,881	23.9%	26.4%	1,101,570	2,344,476
22. NEW YORK (AL)	1,286,811	356,669	27.7%	8,204,529	12,201,209	67.2%	7,278,492	3,281,812	45.1%	40.3%	1,100,000	2,500,000
23. OAKLAND	1,094,500	172,571	15.8%	2,490,555	6,953,064	35.8%	5,458,731	996,222	18.3%	21.5%	767,056	2,130,711
24. SEATTLE	708,306	108,044	15.3%	1,442,416	4,561,572	31.6%	3,696,122	576,966	15.6%	19.0%	221,816	715,537
25. TEXAS	693,057	272,943	39.4%	5,000,000	6,878,703	72.7%	3,878,703	2,000,000	51.6%	43.6%	2,367,561	3,810,503
26. TORONTO (U.S. $) (1)	1,470,407	426,401	29.0%	5,821,824	9,576,720	60.8%	9,576,720	5,821,824	60.8%	0.0%	620,000	1,007,500
TOTAL ALL CLUBS	33,219,243	7,679,942	23.1%	$128,088,942	$278,836,912	45.9%	$208,087,155	$57,339,184	27.6%	25.4%	$48,181,404	$114,776,203
TOTAL U.S. CLUBS	30,464,306	7,038,874	23.1%	$117,916,262	$259,636,504	45.4%	$188,886,747	$47,166,505	25.0%	27.2%	$46,292,729	$107,981,778

(1) Conversion rate, Canadian $ to U.S. $ = 0.775 based on average for 1984 season provided by Office of the Commissioner.

(2) X% = the percentage of business-related purchases assumed lost.

(3) Ticket revenue totals do not include charges for luxury boxes such as skyboxes, but do include normal admission charges for access to such boxes.

BASEBALL COMMISSION
TICKET SALES ANALYSIS

EXHIBIT B

LOSS OF 60% OF BUSINESS-RELATED PURCHASES

CLUB	CONCESSION RECEIPTS						SALES TAX RECEIPTS					
	% BUSINESS OF TOTAL CONCESSIONS	TOTAL CONCESS. MINUS X% OF BUSINESS(2)	TOTAL BUS. CONCESS. MINUS X%(2)	% BUSINESS OF TOTAL AFTER X% DECR (2)	% CONC. LOST FROM X% BUS. LOST (2)	RENT,ETC. PAID TO MUNI.	SALES TAXES FROM BUSINESS	TOTAL SALES TAX	% BUSINESS OF TOTAL SALES TAX	TOT. SALES TAX MINUS X% OF BUSINESS (2)	TOTAL BUS. SALES TAX MINUS X%(2)	% BUSINESS OF TOTAL AFTER X% DECR (2)
1. ATLANTA	39.6%	$6,011,202	$1,415,146	20.0%	23.0%	$2,114,000	$553,242	$1,266,000	43.7%	$934,055	$221,297	23.7%
2. CHICAGO (NL)	26.9%	3,107,000	600,400	12.8%	16.1%	169,960	372,900	1,435,600	26.0%	1,211,060	149,160	12.3%
3. CINCINNATI	46.9%	971,957	253,742	26.1%	28.1%	1,248,000	536,418	1,143,733	46.9%	821,007	214,564	26.1%
4. HOUSTON	60.4%	655,230	248,200	37.9%	36.7%	693,704	39,606	65,942	60.1%	42,170	15,842	37.6%
5. LOS ANGELES	40.2%	13,320,000	2,020,000	24.7%	24.1%	0	440,000	1,150,000	40.0%	874,000	184,000	21.1%
6. MONTREAL (U.S. $) (1)	21.9%	5,706,925	1,260,675	21.9%	0.0%	1,790,000	561,075	1,374,955	40.9%	1,374,955	561,875	40.9%
7. NEW YORK (NL)	40.0%	2,931,026	617,200	21.1%	24.0%	1,021,310	763,500	1,900,726	40.0%	1,450,626	305,100	21.1%
8. PHILADELPHIA	50.0%	4,175,440	1,485,742	35.6%	34.0%	5,085,000	1,514,734	2,399,000	63.1%	1,490,159	605,894	40.7%
9. PITTSBURGH	40.7%	669,000	144,000	21.5%	24.4%	850,448	260,270	611,261	42.6%	455,099	104,160	22.9%
10. ST. LOUIS	45.0%	7,240,200	1,785,200	24.7%	27.0%	0	809,000	1,975,000	45.0%	1,441,600	355,600	24.7%
11. SAN DIEGO	22.0%	2,020,923	204,006	10.1%	13.2%	900,837	80,540	412,454	21.5%	359,330	35,416	9.9%
12. SAN FRANCISCO	26.0%	1,451,537	170,062	12.3%	15.6%	424,941	87,195	335,366	26.0%	283,049	34,870	12.3%
13. BALTIMORE	45.0%	2,951,600	727,600	24.7%	27.0%	1,000,000	411,032	915,103	45.0%	668,004	164,733	24.7%
14. BOSTON	65.9%	2,020,000	880,000	43.6%	39.5%	402,000	150,000	340,000	44.1%	250,000	60,000	24.0%
15. CALIFORNIA	47.1%	7,530,000	1,980,000	26.3%	28.3%	4,900,000	275,000	600,000	45.8%	435,000	110,000	25.3%
16. CHICAGO (AL)	46.6%	3,200,000	800,000	24.4%	26.0%	350,000	675,000	1,350,000	46.3%	975,000	250,000	25.6%
17. CLEVELAND	44.0%	402,000	96,000	23.9%	26.4%	0	50,000	132,661	43.7%	97,861	23,200	23.7%
18. DETROIT	26.2%	3,815,832	476,112	12.4%	15.7%	150,000	0	0	NA	0	0	NA
19. KANSAS CITY	44.4%	3,432,000	832,000	24.2%	26.7%	1,150,000	1,000,000	1,775,000	56.3%	1,175,000	400,000	34.0%
20. MILWAUKEE	35.9%	5,150,400	942,800	18.3%	21.5%	1,645,000	317,200	824,000	38.5%	633,600	126,000	20.0%
21. MINNESOTA	47.0%	1,603,534	400,620	26.2%	28.2%	473,470	705,456	1,603,309	44.0%	1,100,035	202,102	23.9%
22. NEW YORK (AL)	44.0%	1,040,000	440,000	23.9%	26.4%	1,200,000	860,000	1,647,000	52.2%	1,131,600	344,000	30.4%
23. OAKLAND	36.0%	1,670,477	306,872	18.4%	21.6%	1,063,936	60,050	189,029	36.0%	140,159	27,220	18.4%
24. SEATTLE	31.0%	502,447	80,726	15.2%	18.6%	802,342	102,002	331,610	31.3%	269,937	41,121	15.2%
25. TEXAS	62.0%	2,393,046	943,024	39.5%	37.2%	1,000,000	125,297	187,011	67.0%	111,033	50,119	44.8%
26. TORONTO (U.S. $) (1)	61.5%	1,007,300	620,000	61.5%	0.0%	1,162,500	666,500	1,057,000	65.7%	1,457,000	666,500	45.7%
TOTAL ALL CLUBS	42.0%	$87,000,366	$20,005,767	23.5%	24.2%	$30,302,356	$11,492,010	$25,429,040	45.2%	$19,271,427	$5,333,909	27.7%
TOTAL U.S. CLUBS	42.9%	$80,206,141	$18,517,092	23.1%	25.7%	$27,541,056	$10,264,015	$22,597,093	45.4%	$16,439,072	$4,105,614	25.0%

(1) Conversion rate, Canadian $ to U.S. $ = 0.775 based on average for 1984 season provided by Office of the Commissioner.

(2) X% = the percentage of business-related purchases assumed lost.

BASEBALL COMMISSION
TICKET SALES ANALYSIS

EXHIBIT B

LOSS OF 60% OF BUSINESS-RELATED PURCHASES

CLUB	% TIX LOST FROM XX% BUS. LOST (2)	PER CAPITA TICKET AMOUNTS PER CAPITA TICKET AMOUNT	AVERAGE NON-BUSINESS TKT AMOUNT	AVERAGE TKT AMOUNT BUSINESS	AVERAGE TKT AMOUNT MINUS X %(2)	ADJ AVG TKT AMOUNT MINUS X % (2)
1. ATLANTA	26.7%	$6.65	$5.45	$8.98	$8.37	$6.05
2. CHICAGO (NL)	15.6%	5.64	5.28	7.06	6.43	5.44
3. CINCINNATI	20.1%	7.47	8.69	6.43	11.05	7.97
4. HOUSTON	36.0%	7.99	7.60	8.31	11.94	7.04
5. LOS ANGELES	24.0%	6.48	7.14	5.86	9.39	6.76
6. MONTREAL (U.S. $) (1)	0.0%	5.99	7.00	5.09	8.79	8.79
7. NEW YORK (NL)	24.0%	6.52	6.73	6.22	8.71	6.67
8. PHILADELPHIA	37.9%	7.45	6.73	7.90	11.00	7.18
9. PITTSBURGH	25.5%	7.92	8.88	7.04	11.51	8.33
10. ST. LOUIS	27.0%	6.72	7.13	6.27	9.45	6.90
11. SAN DIEGO	12.9%	6.05	5.75	7.09	7.01	5.89
12. SAN FRANCISCO	15.6%	7.74	8.15	6.77	9.42	7.95
13. BALTIMORE	17.0%	5.50	4.97	6.40	7.37	5.30
14. BOSTON	26.5%	6.67	9.19	4.89	10.29	7.63
15. CALIFORNIA	27.5%	5.81	5.74	5.87	8.71	5.70
16. CHICAGO (AL)	27.0%	6.06	5.66	6.63	8.05	5.87
17. CLEVELAND	26.2%	6.02	6.06	5.90	8.21	6.04
18. DETROIT	NA	6.03	5.66	7.07	7.55	5.86
19. KANSAS CITY	31.0%	5.67	4.83	6.64	7.63	5.26
20. MILWAUKEE	23.1%	6.36	5.92	7.16	8.09	6.14
21. MINNESOTA	26.4%	5.33	5.46	5.10	7.32	5.39
22. NEW YORK (AL)	31.3%	6.70	6.30	9.20	9.40	5.66
23. OAKLAND	21.6%	5.14	4.84	5.77	6.35	4.99
24. SEATTLE	10.6%	5.24	5.20	5.34	6.44	5.22
25. TEXAS	40.2%	6.24	4.47	7.53	9.93	5.60
26. TORONTO (U.S. $) (1)	0.0%	4.34	3.60	5.46	6.51	6.51
TOTAL ALL CLUBS	24.2%	$6.23	$5.90	$6.67	$8.39	$6.26
TOTAL U.S. CLUBS	27.3%	$6.33	$6.05	$6.70	$8.52	$6.20

(1) Conversion rate, Canadian $ to U.S. $ = 0.775 based on average for 1984 season provided by Office of the Commissioner.

(2) XX = the percentage of business-related purchases lost.

BASEBALL COMMISSION
TICKET SALES ANALYSIS

EXHIBIT C

LOSS OF 80% OF BUSINESS-RELATED PURCHASES

CLUB	SEASON TICKETS			PARTIAL PLAN TICKETS			SINGLE GAME TICK TS			TOTALS		
	SEASON TICKETS-BUSINESS	TOTAL SEASON TICKETS	% BUSINESS OF SEASON TICKETS	PARTIAL PLAN 1984 BUSINESS	TOTAL PARTIAL PLAN 1984	% BUSINESS OF PARTIAL PLAN	SINGLE GAME-BUSINESS	TOTAL SINGLE GAME	% BUSINESS OF SINGLE GAME	TOTAL TICKETS-BUSINESS	1984 TOTAL TICKETS	% BUSINESS OF TOTAL TICKETS
1. ATLANTA	295,164	370,656	79.6%	41,216	77,556	53.2%	232,787	1,276,700	18.2%	569,167	1,724,892	33.0%
2. CHICAGO (NL)	145,000	181,440	80.4%	45,000	149,296	30.7%	237,722	1,773,483	13.4%	429,330	2,104,219	20.4%
3. CINCINNATI	598,932	777,034	77.0%	10,921	14,184	77.0%	78,003	483,869	16.1%	687,856	1,275,087	53.9%
4. HOUSTON	569,106	675,945	84.2%	52,674	136,464	38.6%	56,015	417,053	13.4%	677,795	1,229,462	55.1%
5. LOS ANGELES	1,506,600	2,167,700	69.7%	0	0	NA	114,233	972,120	11.8%	1,620,833	3,139,820	51.7%
6. MONTREAL (U.S. $) (1)	668,250	910,359	73.4%	20,800	56,000	37.1%	164,993	640,172	25.8%	854,043	1,606,531	53.2%
7. NEW YORK (NL)	420,960	447,400	94.1%	47,275	92,696	51.0%	304,161	1,302,559	23.4%	772,396	1,842,655	41.9%
8. PHILADELPHIA	598,640	635,120	94.3%	533,353	800,255	66.6%	136,673	627,318	21.8%	1,268,666	2,062,693	61.5%
9. PITTSBURGH	269,568	316,872	85.1%	56,550	79,075	71.5%	75,511	377,553	20.0%	401,629	773,500	51.9%
10. ST. LOUIS	665,000	699,672	95.0%	17,000	34,562	49.2%	299,803	1,303,264	23.0%	981,803	2,037,498	48.2%
11. SAN DIEGO	216,200	272,600	79.3%	175,260	482,070	36.4%	61,460	1,229,190	5.0%	452,920	1,983,860	22.8%
12. SAN FRANCISCO	193,647	195,156	99.2%	77,522	276,861	28.0%	26,476	529,528	5.0%	297,645	1,001,545	29.7%
13. BALTIMORE	463,120	654,320	70.8%	63,369	276,324	22.9%	300,000	1,115,140	26.9%	826,489	2,045,784	40.4%
14. BOSTON	290,000	401,000	72.3%	225,000	375,000	60.0%	459,324	885,618	51.9%	974,324	1,661,618	58.6%
15. CALIFORNIA	1,120,230	1,400,247	80.0%	19,500	20,800	93.8%	194,426	981,950	19.8%	1,334,156	2,402,997	55.5%
16. CHICAGO (AL)	465,000	665,000	69.9%	70,000	285,000	24.6%	346,205	1,186,980	29.2%	881,205	2,136,980	41.2%
17. CLEVELAND	116,030	124,394	93.3%	17,040	20,100	84.8%	192,864	589,385	32.7%	325,934	733,879	44.4%
18. DETROIT	293,740	341,924	85.9%	68,985	77,112	89.5%	344,978	2,285,758	15.1%	707,703	2,704,794	26.2%
19. KANSAS CITY	700,000	950,000	73.7%	0	0	NA	94,506	860,018	11.0%	794,506	1,810,018	43.9%
20. MILWAUKEE	391,680	435,200	90.0%	21,266	41,268	51.5%	160,089	1,132,041	14.2%	573,035	1,608,509	35.7%
21. MINNESOTA	170,100	180,954	94.0%	12,500	25,256	49.8%	540,801	1,392,212	38.8%	723,401	1,598,422	45.3%
22. NEW YORK (AL)	702,837	732,159	96.0%	140,877	233,252	60.4%	47,959	856,004	5.6%	891,673	1,821,415	48.9%
23. OAKLAND	193,225	224,800	85.9%	52,132	102,263	51.0%	185,945	1,026,138	18.1%	431,302	1,353,201	31.9%
24. SEATTLE	155,925	205,092	76.0%	3,200	4,160	76.9%	110,985	661,120	16.8%	270,110	870,372	31.0%
25. TEXAS	431,649	454,329	95.0%	750	1,250	60.0%	209,958	686,892	30.6%	642,357	1,142,471	56.2%
26. TORONTO (U.S. $) (1)	656,000	728,000	90.1%	0	0	NA	410,003	1,382,009	29.7%	1,066,003	2,110,009	50.5%
TOTAL ALL CLUBS	12,297,443	15,143,333	81.2%	1,773,020	3,660,734	48.4%	5,129,385	25,935,090	19.8%	19,199,856	44,739,157	42.9%
TOTAL U.S. CLUBS	10,973,193	13,504,974	81.3%	1,752,220	3,604,734	48.6%	4,871,764	23,912,909	20.4%	17,597,185	41,022,617	42.9%

(1) Conversion rate, Canadian $ to U.S. $ = 0.775 based on average for 1984 season provided by Office of the Commissioner

BASEBALL COMMISSION
TICKET SALES ANALYSIS

EXHIBIT C

LOSS OF 80% OF BUSINESS-RELATED PURCHASES

CLUB	TICKETS			TICKET RECEIPTS							CONCESS. RECEIPTS	
	TOTAL TICKETS MINUS X% OF BUSINESS (2)	TOTAL BUS. TICKETS MINUS X %(2)	% BUSINESS OF TOTAL AFTER X% DECR(2)	TOTAL BUSINESS RECEIPTS(3)	TOTAL TICKET RECEIPTS(3)	% BUSINESS OF TOTAL RECEIPTS	TOTAL TICKETS MINUS X% OF BUSINESS (2)	TOTAL BUS. RECEIPTS MINUS X %(2)	% BUSINESS OF TOTAL AFTER X% DECR(2)	% REV. LOST FROM X% BUS. LOSS(2)	CONCESS., NON-TICKET-BUSINESS	CONCESS., NON-TICKET-TOTAL
1. ATLANTA	1,253,559	117,833	9.4%	$5,291,487	$11,478,280	46.1%	$7,245,090	$1,058,297	14.6%	36.9%	$3,537,864	$8,934,000
2. CHICAGO (NL)	1,760,755	85,866	4.9%	3,029,865	11,870,000	25.5%	9,446,108	605,973	6.4%	20.4%	1,021,000	3,800,000
3. CINCINNATI	725,602	137,571	19.0%	4,420,082	9,533,626	46.4%	5,997,560	884,016	14.8%	37.1%	634,356	1,352,571
4. HOUSTON	687,666	135,509	19.7%	5,631,078	9,829,498	57.3%	5,324,636	1,126,216	21.2%	45.8%	620,500	1,027,530
5. LOS ANGELES	1,838,157	324,167	17.6%	9,500,000	20,310,000	46.8%	12,710,000	1,900,000	14.9%	37.4%	7,050,000	17,550,000
6. MONTREAL (U.S. $) (1)	923,297	170,809	18.5%	4,350,855	9,617,680	45.2%	9,617,680	4,350,855	45.2%	0.0%	1,268,675	5,786,925
7. NEW YORK (NL)	1,224,778	154,479	12.6%	4,803,695	12,009,238	40.0%	8,166,282	960,739	11.8%	32.0%	1,543,000	3,857,626
8. PHILADELPHIA	1,047,760	253,733	24.2%	10,016,904	15,356,948	65.2%	7,343,425	2,003,381	27.3%	52.2%	3,714,335	6,404,061
9. PITTSBURGH	452,197	80,326	17.8%	2,825,506	6,128,654	46.1%	3,868,249	565,101	14.6%	36.9%	360,000	885,000
10. ST. LOUIS	1,231,942	196,377	15.7%	6,160,000	13,689,543	45.0%	8,761,543	1,232,000	14.1%	36.0%	4,463,000	9,918,000
11. SAN DIEGO	1,621,536	90,592	5.6%	3,211,884	12,008,083	26.8%	9,438,576	642,377	6.8%	21.4%	512,216	2,320,253
12. SAN FRANCISCO	763,429	59,529	7.8%	2,014,697	7,748,836	26.0%	6,137,078	402,939	6.6%	20.8%	447,155	1,719,030
13. BALTIMORE	1,384,593	165,290	11.9%	5,357,628	11,421,520	46.9%	7,135,418	1,071,526	15.0%	37.5%	1,019,000	4,043,000
14. BOSTON	882,159	194,865	22.1%	4,767,000	11,083,082	43.0%	7,269,482	953,400	13.1%	34.4%	2,200,000	3,340,000
15. CALIFORNIA	1,335,672	266,031	20.0%	7,825,000	13,956,220	56.1%	7,696,220	1,565,000	20.3%	44.9%	4,950,000	10,500,000
16. CHICAGO (AL)	1,432,028	176,248	12.3%	5,839,976	12,947,797	45.1%	8,275,816	1,167,995	14.1%	36.1%	2,000,000	4,480,000
17. CLEVELAND	473,332	65,187	13.8%	1,947,757	4,422,030	44.0%	2,863,825	389,551	13.6%	35.2%	240,000	546,000
18. DETROIT	2,130,632	141,541	6.6%	5,000,429	16,312,334	30.7%	12,311,991	1,000,086	8.1%	24.5%	1,190,200	4,330,000
19. KANSAS CITY	1,174,414	158,901	13.5%	5,275,000	10,177,003	51.8%	5,957,003	1,055,000	17.7%	41.5%	2,000,000	4,689,000
20. MILWAUKEE	1,149,441	114,767	10.0%	4,108,571	10,233,197	40.1%	6,946,340	821,714	11.8%	32.1%	2,357,000	6,564,600
21. MINNESOTA	1,019,637	144,696	14.2%	3,747,203	8,520,680	44.0%	5,522,917	749,441	13.6%	35.2%	1,101,570	2,344,676
22. NEW YORK (AL)	1,100,477	178,335	16.1%	8,204,529	12,201,299	67.2%	5,637,676	1,640,906	29.1%	53.8%	1,100,000	2,500,000
23. OAKLAND	1,008,239	86,260	8.6%	2,490,555	6,953,064	35.8%	4,960,620	498,111	10.0%	28.7%	767,854	2,130,711
24. SEATTLE	654,204	54,022	8.3%	1,442,416	4,561,572	31.6%	3,407,639	288,483	8.5%	25.3%	221,046	715,537
25. TEXAS	556,503	136,471	24.5%	5,000,000	6,870,703	72.7%	2,870,703	1,000,000	34.7%	58.2%	2,362,561	3,010,503
26. TORONTO (U.S. $) (1)	1,257,207	213,201	17.0%	5,821,824	9,576,728	60.8%	9,576,728	5,821,824	60.8%	0.0%	620,000	1,007,500
TOTAL ALL CLUBS	29,379,272	5,039,971	13.1%	$128,088,942	$278,830,912	45.9%	$184,497,902	$33,755,932	18.3%	33.8%	$48,181,404	$114,776,203
TOTAL U.S. CLUBS	26,944,869	3,519,437	13.1%	$117,916,262	$259,636,504	45.4%	$165,303,494	$23,583,252	14.3%	36.3%	$46,292,729	$107,981,778

(1) Conversion rate, Canadian $ to U.S. $ = 0.775 based on average for 1984 season provided by Office of the Commissioner.

(2) X% = the percentage of business-related purchases assumed lost.

(3) Ticket revenue totals do not include charges for luxury boxes such as skyboxes, but do include normal admission charges for access to such boxes.

BASEBALL COMMISSION
TICKET SALES ANALYSIS

EXHIBIT C

LOSS OF 80% OF BUSINESS-RELATED PURCHASES

CLUB	CONCESSION RECEIPTS						SALES TAX RECEIPTS					
	% BUSINESS OF TOTAL CONCESSIONS	TOTAL CONCESS. MINUS XX OF BUSINESS (2)	TOTAL BUS. CONCESS. MINUS X % (2)	% BUSINESS OF TOTAL AFTER XX DECR (2)	% CONC. LOST FROM XX BUS. LOST (2)	RENT, ETC. PAID TO MGMT.	SALES TAXES FROM BUSINESS	TOTAL SALES TAX	% BUSINESS OF TOTAL SALES TAX	TOT. SALES TAX MINUS XX OF BUSINESS (2)	TOTAL BUS. SALES TAX MINUS X % (2)	% BUSINESS OF TOTAL AFTER XX DECR (2)
1. ATLANTA	39.6%	$6,103,709	$707,573	11.6%	31.7%	$2,114,000	$553,242	$1,266,000	43.7%	$823,406	$110,648	13.4%
2. CHICAGO (NL)	26.9%	2,903,200	204,200	6.8%	21.5%	169,960	372,900	1,435,600	26.0%	1,137,280	74,580	6.6%
3. CINCINNATI	46.9%	845,086	126,871	15.0%	37.5%	1,240,000	536,410	1,143,733	46.9%	714,605	107,282	15.0%
4. HOUSTON	60.4%	531,130	174,100	23.4%	40.3%	693,704	39,606	65,942	60.1%	34,257	7,921	23.1%
5. LOS ANGELES	40.2%	11,910,000	1,418,000	11.8%	32.1%	0	660,000	1,150,000	40.0%	782,000	92,000	11.8%
6. MONTREAL (U.S. $) (1)	21.9%	5,706,925	1,268,675	21.9%	0.0%	1,798,000	561,875	1,374,955	40.9%	1,374,955	561,875	40.9%
7. NEW YORK (NL)	40.0%	2,623,226	308,600	11.8%	32.0%	1,021,310	763,500	1,908,726	40.0%	1,297,926	152,700	11.8%
8. PHILADELPHIA	58.0%	3,432,577	742,871	21.6%	46.4%	5,085,000	1,514,734	2,399,000	63.1%	1,187,212	302,947	25.5%
9. PITTSBURGH	40.7%	597,000	72,000	12.1%	32.5%	858,460	260,270	611,261	42.6%	403,045	52,054	12.9%
10. ST. LOUIS	45.0%	6,347,600	892,600	14.1%	36.0%	0	889,000	1,975,000	45.0%	1,263,000	177,800	14.1%
11. SAN DIEGO	22.0%	1,918,480	102,643	5.3%	17.6%	988,037	88,540	412,454	21.5%	341,622	17,708	5.2%
12. SAN FRANCISCO	26.0%	1,362,106	89,431	6.6%	20.8%	474,941	87,195	335,366	26.0%	265,610	17,439	6.6%
13. BALTIMORE	45.0%	2,587,000	363,000	14.1%	36.0%	1,000,000	411,832	915,183	45.0%	585,717	82,366	14.1%
14. BOSTON	65.9%	1,580,000	440,000	27.8%	52.7%	402,000	150,000	340,000	44.1%	220,000	30,000	13.6%
15. CALIFORNIA	47.1%	6,540,000	990,000	15.1%	37.7%	4,900,000	275,000	600,000	45.8%	380,000	55,000	14.5%
16. CHICAGO (AL)	44.6%	2,000,000	400,000	13.9%	35.7%	350,000	625,000	1,350,000	46.3%	850,000	125,000	14.7%
17. CLEVELAND	44.0%	334,000	48,000	13.6%	35.2%	0	58,000	132,666	43.7%	86,261	11,600	13.4%
18. DETROIT	26.2%	3,597,776	238,056	6.6%	20.9%	150,000	0	0	NA	0	0	NA
19. KANSAS CITY	44.4%	3,016,000	416,000	13.8%	35.6%	1,150,000	1,000,000	1,775,000	56.3%	975,000	200,000	20.5%
20. MILWAUKEE	35.9%	4,679,000	471,400	10.1%	28.7%	1,645,000	317,200	824,000	38.5%	570,240	63,440	11.1%
21. MINNESOTA	47.0%	1,163,220	220,314	15.1%	37.6%	473,470	705,456	1,603,309	44.0%	1,038,944	141,091	13.6%
22. NEW YORK (AL)	44.0%	1,620,000	220,000	13.6%	35.2%	1,200,000	840,000	1,647,000	57.2%	959,000	172,000	17.9%
23. OAKLAND	36.0%	1,517,066	153,411	10.1%	28.8%	1,863,936	60,650	189,029	36.0%	134,509	13,610	10.1%
24. SEATTLE	31.0%	538,004	44,363	8.2%	24.8%	802,342	102,802	331,618	31.0%	249,376	20,560	8.2%
25. TEXAS	62.0%	1,920,534	472,512	24.6%	49.6%	1,000,000	125,297	187,011	67.0%	86,773	25,059	28.9%
26. TORONTO (U.S. $) (1)	61.5%	1,007,500	620,000	61.5%	0.0%	1,162,500	666,500	1,057,000	65.7%	1,057,000	666,500	65.7%
TOTAL ALL CLUBS	42.0%	$77,742,820	$11,147,221	14.3%	32.3%	$30,502,356	$11,492,410	$25,429,848	45.2%	$17,218,620	$3,201,182	19.1%
TOTAL U.S. CLUBS	42.9%	$70,947,595	$9,258,546	13.0%	34.3%	$27,541,856	$10,264,035	$22,597,893	45.4%	$14,306,665	$2,652,807	14.3%

(1) Conversion rate, Canadian $ to U.S. $ = 0.775 based on average for 1984 season provided by Office of the Commissioner.

(2) XX = the percentage of business-related purchases assumed lost.

BASEBALL COMMISSION
TICKET SALES ANALYSIS

EXHIBIT C

LOSS OF 80% OF BUSINESS-RELATED PURCHASES

CLUB	% TIX LOST FROM XX BUS. LOST (2)	PER CAPITA TICKET AMOUNT	AVERAGE NON BUSINESS TKT-AMOUNT	AVERAGE TKT AMOUNT BUSINESS	AVERAGE TKT-AMOUNT MINUS X %	ADJ AVG TKT-AMOUNT MINUS X % (2)
		PER CAPITA TICKET AMOUNTS				
1. ATLANTA	35.0%	$6.65	$5.45	$8.90	$9.16	$5.78
2. CHICAGO (NL)	20.0%	5.44	5.20	7.06	6.78	5.36
3. CINCINNATI	37.5%	7.47	8.69	6.63	13.14	8.27
4. HOUSTON	40.0%	7.99	7.60	8.31	14.29	7.74
5. LOS ANGELES	32.0%	6.40	7.14	5.06	11.05	6.91
6. MONTREAL (U.S. $) (1)	0.0%	5.99	7.00	5.09	10.42	10.42
7. NEW YORK (NL)	32.0%	6.52	6.75	6.22	9.81	6.67
8. PHILADELPHIA	50.5%	7.45	6.73	7.90	14.66	7.01
9. PITTSBURGH	34.1%	7.92	8.00	7.04	13.55	8.56
10. ST. LOUIS	36.0%	6.72	7.13	6.27	10.93	7.00
11. SAN DIEGO	17.2%	6.05	5.75	7.09	7.41	5.82
12. SAN FRANCISCO	20.0%	7.74	8.15	6.77	10.15	8.04
13. BALTIMORE	36.0%	5.50	4.97	6.40	8.25	5.15
14. BOSTON	35.3%	6.67	9.19	4.09	12.56	8.24
15. CALIFORNIA	36.7%	5.01	5.74	5.87	10.45	5.76
16. CHICAGO (AL)	37.0%	6.06	5.66	6.63	9.04	5.70
17. CLEVELAND	35.6%	6.02	6.06	5.98	9.34	6.05
18. DETROIT	NA	6.03	5.66	7.07	7.63	5.76
19. KANSAS CITY	45.1%	5.62	4.83	6.64	8.67	5.07
20. MILWAUKEE	30.0%	6.36	5.92	7.16	8.90	6.04
21. MINNESOTA	35.2%	5.33	5.46	5.18	8.36	5.42
22. NEW YORK (AL)	41.0%	6.70	4.30	9.20	11.01	5.09
23. OAKLAND	20.0%	5.14	4.04	5.77	6.90	4.92
24. SEATTLE	24.0%	5.24	5.20	5.30	6.97	5.21
25. TEXAS	53.6%	6.24	4.47	7.33	12.36	5.17
26. TORONTO (U.S. $) (1)	0.0%	4.54	3.60	5.46	7.62	7.62
TOTAL ALL CLUBS	32.3%	$6.23	$5.90	$6.67	$9.49	$6.20
TOTAL U.S. CLUBS	36.3%	$6.33	$6.05	$6.70	$9.64	$6.13

(1) Conversion rate, Canadian $ to U.S. $ = 0.775 based on average for 1986 season provided by Office of the Commissioner.

(2) X% = the percentage of business-related purchases lost.

BASEBALL COMMISSION
TICKET SALES ANALYSIS

EXHIBIT D

LOSS OF 100% OF BUSINESS-RELATED PURCHASES

CLUB	SEASON TICKETS			PARTIAL PLAN TICKETS			SINGLE GAME TICKETS			TOTALS		
	SEASON TICKETS-BUSINESS	TOTAL SEASON TICKETS	% BUSINESS OF SEASON TICKETS	PARTIAL PLAN 1984 BUSINESS	TOTAL PARTIAL PLAN 1984	% BUSINESS OF PARTIAL PLAN	SINGLE GAME BUSINESS	TOTAL SINGLE GAME	% BUSINESS OF SINGLE GAME	TOTAL TICKETS-BUSINESS	1984 TOTAL TICKETS	% BUSINESS OF TOTAL TICKETS
1. ATLANTA	295,164	370,656	79.6%	41,216	77,536	53.2%	252,787	1,276,700	19.8%	589,167	1,724,892	34.2%
2. CHICAGO (NL)	145,000	181,440	80.4%	45,000	149,296	30.7%	237,722	1,773,483	13.4%	429,330	2,104,219	20.4%
3. CINCINNATI	598,932	777,034	77.0%	10,921	14,184	77.0%	78,003	483,869	16.1%	687,856	1,275,087	53.9%
4. HOUSTON	569,106	675,985	84.2%	52,624	136,444	38.6%	56,015	417,433	13.4%	677,745	1,229,862	55.1%
5. LOS ANGELES	1,506,600	2,162,700	69.7%	0	0	NA	114,233	972,124	11.8%	1,620,833	3,134,824	51.7%
6. MONTREAL (U.S. $) (1)	668,250	910,359	73.4%	20,800	56,000	37.1%	164,993	640,172	25.8%	854,043	1,606,531	53.2%
7. NEW YORK (NL)	420,960	447,400	94.1%	47,275	92,696	51.0%	304,161	1,302,559	23.4%	772,396	1,842,695	41.9%
8. PHILADELPHIA	598,640	635,120	94.3%	533,353	800,255	66.6%	136,673	627,318	21.8%	1,268,666	2,062,693	61.5%
9. PITTSBURGH	269,568	316,872	85.1%	56,550	79,075	71.5%	75,511	377,553	20.0%	401,629	773,500	51.9%
10. ST. LOUIS	665,000	699,672	95.0%	17,000	34,512	49.3%	299,083	1,303,264	23.0%	981,083	2,037,448	48.2%
11. SAN DIEGO	216,200	272,640	79.3%	175,260	482,070	36.4%	61,460	1,229,194	5.0%	452,960	1,983,904	22.8%
12. SAN FRANCISCO	193,647	195,156	99.2%	77,522	276,861	28.0%	26,476	529,328	5.0%	297,645	1,001,345	29.7%
13. BALTIMORE	463,120	654,320	70.8%	63,369	276,324	22.9%	300,000	1,115,060	26.9%	826,489	2,045,704	40.4%
14. BOSTON	290,000	401,000	72.3%	225,000	375,000	60.0%	459,324	885,610	51.9%	974,324	1,661,610	58.6%
15. CALIFORNIA	1,120,230	1,400,247	80.0%	19,500	20,800	93.8%	194,426	981,950	19.8%	1,334,156	2,402,997	55.5%
16. CHICAGO (AL)	465,000	665,000	69.9%	70,000	285,000	24.6%	346,205	1,186,980	29.2%	881,205	2,136,980	41.2%
17. CLEVELAND	116,030	124,394	93.3%	17,040	20,100	84.8%	192,864	589,585	32.7%	325,934	734,079	44.4%
18. DETROIT	293,740	341,924	85.9%	68,985	77,112	89.5%	344,978	2,285,758	15.1%	707,703	2,704,794	26.2%
19. KANSAS CITY	700,000	950,000	73.7%	0	0	NA	94,506	860,018	11.0%	794,506	1,810,018	43.9%
20. MILWAUKEE	391,600	435,200	90.0%	21,266	41,268	51.5%	160,969	1,132,041	14.2%	573,835	1,608,509	35.7%
21. MINNESOTA	170,100	180,954	94.0%	12,500	25,256	49.5%	540,881	1,392,212	38.8%	723,481	1,598,422	45.3%
22. NEW YORK (AL)	702,837	732,159	96.0%	140,877	233,252	60.4%	47,959	856,404	5.6%	891,673	1,821,815	48.9%
23. OAKLAND	193,225	224,880	85.9%	52,132	102,263	51.0%	185,945	1,026,138	18.1%	431,302	1,353,281	31.9%
24. SEATTLE	155,925	205,092	76.0%	3,200	4,160	76.9%	110,985	661,120	16.8%	270,110	870,372	31.0%
25. TEXAS	431,649	454,329	95.0%	750	1,250	60.0%	249,958	646,892	38.6%	682,357	1,102,471	61.9%
26. TORONTO (U.S. $) (1)	656,000	728,000	90.1%	0	0	NA	410,003	1,382,009	29.7%	1,066,003	2,110,009	50.5%
TOTAL ALL CLUBS	12,297,443	15,143,333	81.2%	1,773,020	3,660,734	48.4%	5,129,385	25,935,090	19.8%	19,199,856	44,739,157	42.9%
TOTAL U.S. CLUBS	10,973,193	13,504,974	81.3%	1,752,220	3,604,734	48.6%	4,871,764	23,912,909	20.4%	17,597,185	41,022,617	42.9%

(1) Conversion rate, Canadian $ to U.S. $ = 0.775 based on average for 1984 season provided by Office of the Commissioner.

BASEBALL COMMISSION
TICKET SALES ANALYSIS

EXHIBIT D

LOSS OF 100% OF BUSINESS-RELATED PURCHASES

	TICKETS			TICKET RECEIPTS							CONCESS. RECEIPTS	
CLUB	TOTAL TICKETS MINUS X% OF BUSINESS (2)	TOTAL BUS. TICKETS MINUS X % (2)	% BUSINESS OF TOTAL AFTER X% DECR (2)	TOTAL BUSINESS RECEIPTS (3)	TOTAL TICKET RECEIPTS (3)	% BUSINESS OF TOTAL RECEIPTS	TOTAL TICKETS MINUS X% OF BUSINESS (2)	TOTAL BUS. RECEIPTS MINUS X % (2)	% BUSINESS OF TOTAL AFTER X% DECR (2)	% REV. LOST FROM X% BUS. LOST (2)	CONCESS., NON-TICKET-BUSINESS	CONCESS., NON-TICKET-TOTAL
1. ATLANTA	1,135,725	0	0.0%	$5,291,407	$11,478,200	46.1%	$6,186,793	$0	0.0%	46.1%	$3,537,864	$8,934,000
2. CHICAGO (NL)	1,674,009	0	0.0%	3,029,865	11,870,000	25.5%	8,840,135	0	0.0%	25.5%	1,021,000	3,800,000
3. CINCINNATI	588,031	0	0.0%	4,424,082	9,536,826	46.4%	5,112,744	0	0.0%	46.4%	634,356	1,352,571
4. HOUSTON	552,117	0	0.0%	5,631,078	9,829,498	57.3%	4,198,420	0	0.0%	57.3%	620,500	1,027,530
5. LOS ANGELES	1,513,991	0	0.0%	9,500,000	20,310,000	46.8%	10,810,000	0	0.0%	46.8%	7,050,000	17,550,000
6. MONTREAL (U.S. $) (1)	752,488	0	0.0%	4,350,855	9,617,680	45.2%	9,617,680	4,350,855	45.2%	0.0%	1,268,675	5,786,925
7. NEW YORK (NL)	1,070,299	0	0.0%	4,803,695	12,009,238	40.0%	7,205,543	0	0.0%	40.0%	1,543,000	3,857,626
8. PHILADELPHIA	794,027	0	0.0%	10,016,904	15,356,948	65.2%	5,340,044	0	0.0%	65.2%	3,714,355	6,404,061
9. PITTSBURGH	371,871	0	0.0%	2,825,506	6,129,153	46.1%	3,303,647	0	0.0%	46.1%	360,000	805,000
10. ST. LOUIS	1,055,565	0	0.0%	6,160,000	13,689,543	45.0%	7,529,543	0	0.0%	45.0%	4,463,006	9,918,000
11. SAN DIEGO	1,530,944	0	0.0%	3,212,884	12,008,883	26.8%	8,795,999	0	0.0%	26.8%	512,716	2,320,253
12. SAN FRANCISCO	703,900	0	0.0%	2,014,697	7,748,836	26.0%	5,734,139	0	0.0%	26.0%	447,155	1,719,830
13. BALTIMORE	1,219,295	0	0.0%	5,357,628	11,421,520	46.9%	6,063,892	0	0.0%	46.9%	1,819,000	4,043,000
14. BOSTON	687,294	0	0.0%	4,767,000	11,083,002	43.0%	6,316,002	0	0.0%	43.0%	2,200,000	3,340,000
15. CALIFORNIA	1,068,841	0	0.0%	7,825,000	13,956,228	56.1%	6,131,228	0	0.0%	56.1%	4,950,000	10,500,000
16. CHICAGO (AL)	1,255,703	0	0.0%	5,839,976	12,947,797	45.1%	7,107,821	0	0.0%	45.1%	2,000,000	4,400,000
17. CLEVELAND	408,145	0	0.0%	1,947,757	4,422,030	44.0%	2,474,273	0	0.0%	44.0%	240,000	546,000
18. DETROIT	1,997,091	0	0.0%	5,000,429	16,312,334	30.7%	11,311,905	0	0.0%	30.7%	1,190,280	4,550,000
19. KANSAS CITY	1,015,512	0	0.0%	5,275,000	10,177,083	51.8%	4,902,083	0	0.0%	51.8%	2,000,000	4,600,000
20. MILWAUKEE	1,034,674	0	0.0%	4,108,571	10,233,197	40.1%	6,124,626	0	0.0%	40.1%	2,357,000	6,564,600
21. MINNESOTA	874,941	0	0.0%	3,747,203	8,520,680	44.0%	4,773,477	0	0.0%	44.0%	1,101,576	2,344,476
22. NEW YORK (AL)	930,142	0	0.0%	8,204,529	12,201,209	67.2%	3,996,680	0	0.0%	67.2%	1,100,000	2,500,000
23. OAKLAND	921,979	0	0.0%	2,490,555	6,953,064	35.8%	4,462,509	0	0.0%	35.8%	767,056	2,130,711
24. SEATTLE	600,262	0	0.0%	1,442,416	4,561,572	31.6%	3,119,156	0	0.0%	31.6%	221,016	715,537
25. TEXAS	420,114	0	0.0%	5,000,000	6,878,703	72.7%	1,878,703	0	0.0%	72.7%	2,362,561	3,010,583
26. TORONTO (U.S. $) (1)	1,044,006	0	0.0%	5,821,824	9,576,728	60.8%	9,576,728	5,821,824	60.8%	0.0%	620,000	1,007,500
TOTAL ALL CLUBS	25,539,301	0	0.0%	$128,088,942	$278,850,912	45.9%	$160,934,649	$10,172,679	6.3%	42.3%	$48,181,404	$114,776,203
TOTAL U.S. CLUBS	23,425,432	0	0.0%	$117,916,262	$259,636,504	45.4%	$141,720,242	$0	0.0%	45.4%	$46,292,729	$107,981,778

(1) Conversion rate, Canadian $ to U.S. $ = 0.775 based on average for 1984 season provided by Office of the Commissioner.

(2) X% = the percentage of business-related purchases assumed lost.

(3) Ticket revenue totals do not include charges for luxury boxes such as skyboxes, but do include normal admission charges for access to such boxes.

BASEBALL COMMISSION
TICKET SALES ANALYSIS

EXHIBIT D

LOSS OF 100% OF BUSINESS-RELATED PURCHASES

CLUB	CONCESSION RECEIPTS						SALES TAX RECEIPTS					
	% BUSINESS OF TOTAL CONCESSIONS	TOTAL CONCESS. MINUS XX OF BUSINESS(2)	TOTAL BUS. CONCESS. MINUS X X (2)	% BUSINESS OF TOTAL AFTER XX DECR (2)	% CONC. LOST FROM XX BUS. LOST(2)	RENT,ETC. PAID TO [illegible]	SALES TAXES FROM BUSINESS	TOTAL SALES TAX	% BUSINESS OF TOTAL SALES TAX	TOT. SALES TAX MINUS XX OF BUSINESS(2)	TOTAL BUS. SALES TAX MINUS X X(2)	% BUSINESS OF TOTAL AFTER XX DECR (2)
1. ATLANTA	39.6%	$5,396,136	$0	0.0%	39.6%	$2,114,000	$553,282	$1,266,000	43.7%	$712,750	$0	0.0%
2. CHICAGO (NL)	26.9%	2,779,000	0	0.0%	26.9%	169,960	372,900	1,435,600	26.0%	1,062,700	0	0.0%
3. CINCINNATI	46.9%	718,215	0	0.0%	46.9%	1,240,000	536,410	1,143,733	46.9%	607,323	0	0.0%
4. HOUSTON	60.1%	607,030	0	0.0%	60.1%	893,764	39,606	65,942	60.1%	26,336	0	0.0%
5. LOS ANGELES	40.2%	10,500,000	0	0.0%	40.2%	0	460,000	1,150,000	40.0%	690,000	0	0.0%
6. MONTREAL (U.S. $) (1)	21.9%	5,786,925	1,268,675	21.9%	0.0%	1,790,000	561,875	1,374,955	40.9%	1,374,955	561,875	40.9%
7. NEW YORK (NL)	40.0%	2,314,626	0	0.0%	40.0%	1,021,310	763,500	1,908,726	40.0%	1,145,226	0	0.0%
8. PHILADELPHIA	58.0%	2,609,706	0	0.0%	58.0%	5,085,000	1,514,734	2,399,000	63.1%	884,266	0	0.0%
9. PITTSBURGH	40.7%	575,000	0	0.0%	40.7%	858,460	260,270	611,261	42.6%	350,991	0	0.0%
10. ST. LOUIS	45.0%	5,455,000	0	0.0%	45.0%	0	889,000	1,975,000	45.0%	1,086,000	0	0.0%
11. SAN DIEGO	22.0%	1,816,037	0	0.0%	22.0%	988,037	88,540	412,454	21.5%	323,914	0	0.0%
12. SAN FRANCISCO	26.0%	1,272,675	0	0.0%	26.0%	424,941	87,195	335,366	26.0%	248,171	0	0.0%
13. BALTIMORE	45.0%	2,224,000	0	0.0%	45.0%	1,000,000	411,832	915,183	45.0%	503,351	0	0.0%
14. BOSTON	65.9%	1,140,000	0	0.0%	65.9%	402,000	150,000	340,000	44.1%	190,000	0	0.0%
15. CALIFORNIA	47.1%	5,550,000	0	0.0%	47.1%	4,900,000	275,000	600,000	45.8%	325,000	0	0.0%
16. CHICAGO (AL)	44.6%	2,400,000	0	0.0%	44.6%	350,000	625,000	1,350,000	46.3%	725,000	0	0.0%
17. CLEVELAND	44.0%	906,000	0	0.0%	44.0%	0	58,000	132,661	43.7%	74,661	0	0.0%
18. DETROIT	26.2%	3,359,720	0	0.0%	26.2%	150,000	0	0	NA	0	0	NA
19. KANSAS CITY	44.4%	2,600,000	0	0.0%	44.4%	1,150,000	1,000,000	1,775,000	56.3%	775,000	0	0.0%
20. MILWAUKEE	35.9%	4,207,600	0	0.0%	35.7%	1,645,000	317,200	824,000	38.5%	506,800	0	0.0%
21. MINNESOTA	47.0%	1,242,906	0	0.0%	47.0%	473,470	705,456	1,603,309	44.0%	897,853	0	0.0%
22. NEW YORK (AL)	44.0%	1,400,000	0	0.0%	44.0%	1,200,000	860,000	1,647,000	52.2%	787,000	0	0.0%
23. OAKLAND	36.0%	1,363,655	0	0.0%	36.0%	1,863,936	68,050	189,029	36.0%	120,979	0	0.0%
24. SEATTLE	31.0%	493,721	0	0.0%	31.0%	802,347	102,802	331,618	31.0%	228,816	0	0.0%
25. TEXAS	62.0%	1,448,022	0	0.0%	62.0%	1,000,000	125,297	187,011	67.0%	61,714	0	0.0%
26. TORONTO (U.S. $) (1)	61.5%	1,007,500	620,000	61.5%	0.0%	1,162,500	666,500	1,457,000	45.7%	1,457,000	666,500	45.7%
TOTAL ALL CLUBS	42.0%	$68,403,474	$1,888,675	2.8%	40.3%	$30,502,356	$11,492,410	$25,479,848	45.2%	$15,165,813	$1,228,375	4.8%
TOTAL U.S. CLUBS	42.9%	$61,609,049	$0	0.0%	42.9%	$27,541,856	$10,264,035	$22,597,893	45.4%	$12,333,858	$0	0.0%

(1) Conversion rate, Canadian $ to U.S. $ = 0.775 based on average for 1984 season provided by Office of the Commissioner.

(2) XX = the percentage of business-related purchases assumed lost.

BASEBALL COMMISSION
TICKET SALES ANALYSIS

EXHIBIT D

LOSS OF 100% OF BUSINESS-RELATED PURCHASES

CLUB	% TKT LOST FROM X% BUS. LOST(2)	PER CAPITA TICKET AMOUNTS PER CAPITA TICKET AMOUNT	AVERAGE NON BUSINESS TKT-AMOUNT	AVERAGE TKT-AMOUNT BUSINESS	AVERAGE TKT-AMOUNT MINUS X %(2)	ADJ AVG TKT-AMOUNT MINUS X %(2)
1. ATLANTA	43.7%	$6.65	$5.05	$8.90	$10.11	$5.45
2. CHICAGO (NL)	26.0%	5.64	5.20	7.06	7.09	5.20
3. CINCINNATI	46.9%	7.47	8.69	6.43	16.22	8.69
4. HOUSTON	50.1%	7.99	7.60	8.31	17.80	7.60
5. LOS ANGELES	40.0%	6.48	7.14	5.86	13.41	7.14
6. MONTREAL (U.S. $) (1)	0.0%	5.99	7.00	5.09	12.78	12.38
7. NEW YORK (NL)	40.0%	6.52	6.73	6.22	11.22	6.73
8. PHILADELPHIA	63.1%	7.45	6.73	7.90	19.34	6.73
9. PITTSBURGH	42.6%	7.92	8.88	7.04	16.48	8.88
10. ST. LOUIS	45.0%	6.72	7.13	6.27	12.97	7.13
11. SAN DIEGO	21.5%	6.65	5.75	7.09	7.84	5.75
12. SAN FRANCISCO	26.0%	7.74	8.15	6.77	11.01	8.15
13. BALTIMORE	45.0%	5.50	4.97	6.40	9.37	4.97
14. BOSTON	44.1%	6.67	9.19	4.09	16.13	9.19
15. CALIFORNIA	45.0%	5.81	5.74	5.87	13.06	5.74
16. CHICAGO (AL)	46.3%	6.06	5.66	6.63	10.31	5.65
17. CLEVELAND	43.7%	6.02	6.06	5.98	10.83	6.06
18. DETROIT	NA	6.03	5.66	7.07	8.17	5.66
19. KANSAS CITY	56.3%	5.62	4.83	6.64	10.02	4.83
20. MILWAUKEE	38.5%	6.36	5.92	7.16	9.89	5.92
21. MINNESOTA	44.0%	5.33	5.46	5.18	9.74	5.46
22. NEW YORK (AL)	52.2%	6.70	4.30	9.20	13.12	4.30
23. OAKLAND	[illegible]	5.14	4.84	5.77	7.54	4.84
24. SEATTLE	31.0%	5.24	5.20	5.34	7.60	5.20
25. TEXAS	67.0%	6.24	4.47	7.33	16.37	4.47
26. TORONTO (U.S. $) (1)	0.0%	4.54	3.60	5.46	9.17	9.17
TOTAL ALL CLUBS	[illegible]	$6.23	$5.90	$6.67	$10.92	$6.30
TOTAL U.S. CLUBS	45.4%	$6.33	$6.05	$6.70	$11.00	$6.05

(1) Conversion rate, Canadian $ to U.S. $ = 0.775 based on average for 1984 season provided by Office of the Commissioner.

(2) X% = the percentage of business-related purchases lost.

EXHIBIT "B"

MAJOR LEAGUE BASEBALL 1976 - 1988

	Operating Revenue	Operating Expenses	Profit (Loss)
1976	$182,035,149	$186,704,462	$(4,669,313)
1977	233,285,111	236,155,850	(2,870,739)
1978	265,308,026	265,303,440	4,586
1979	301,750,111	302,363,300	(613,189)
1980	351,404,624	371,177,557	(19,772,933)
1981*	279,148,414	384,533,669	(105,385,255)
1982	442,642,488	534,737,436	(92,094,948)
1983	521,656,909	588,260,780	(66,603,871)
1984	625,270,000	653,773,000	(28,503,000)
1985**	690,000,000	719,000,000	(29,000,000)
1986**	728,000,000	787,000,000	(59,000,000)
1987**	796,000,000	860,000,000	(64,000,000)
1988**	849,000,000	935,000,000	(86,000,000)

* Strike year. Does not include strike insurance proceeds of $46,800,000.

** The years 1985-88 are projected from 1984 as a base year.

EXHIBIT "C"

SUMMARY ANALYSIS OF MAJOR LEAGUE BASEBALL'S OPERATING POSITION

	1983	1984*
Income from Baseball Operations	$521,656,909	$625,270,000
Operating Income (Loss)	(66,603,871)	(28,503,000)
Average Income (Loss) per Club	(2,511,687)	(1,096,269)

Profit (Loss) of Number of Clubs	1983	1984*
Profit over 3M	1	2
Profit 3 - 2M	1	1
Profit 2 - 1M	1	2
Profit under 1M	5	1
Loss under 1M	1	4
Loss 1 - 2M	6	6
Loss 2 - 3M	1	2
Loss 3 - 4M	2	1
Loss 4 - 5M	2	4
Loss 5 - 6M	3	1
Loss over 6M	3	2

* 1984 figures reflect revenues from the new national broadcasting contracts and make no provisions for the $9.5 million retroactive Benefit Plan contribution negotiated with the Players Association in August 1985.

STATEMENT OF ABE POLLIN, CHAIRMAN AND PRINCIPAL OWNER, WASHINGTON BULLETS, WASHINGTON CAPITALS, AND CAPITAL CENTRE ARENA, WASHINGTON, DC

Mr. POLLIN. Good morning. My name is Abe Pollin. I am the principal owner of the Washington Bullets basketball team, the Washington Capitals hockey team, and the Capital Centre where both teams play. I have been involved as an owner in professional sports for over 21 years and feel I am qualified to address the problems that this proposed tax bill has in its effect on sports. I would like to make three distinct points this morning. No. 1, how the proposed tax bill would affect season ticket and individual game sales. It has been determined by studies made by Dr. Edward Shils of the Wharton School, University of Pennsylvania, through extensive polling throughout the country that 56 percent of all ticket sales that were purchased by companies for legitimate business purposes would be discontinued—56 percent. That translates into 25 percent of total revenue—25 percent of total revenue—of the total team revenue that would be lost. Many teams are now losing large sums of money or are on the verge, and this additional loss of 25 percent of revenue could be disastrous. I would like to give you an example.

In 1982, after having suffered in excess of $20 million in losses with the Washington Capitals, my hockey team, I was faced with two alternatives: one, disbanding the team, or two, move the team out of the city. At that time, the Washington business community came to the fore. They bought in excess of 6,000 season tickets and they underwrote the first 12 home games at a cost of over $100,000 per game. This business community could not, and would not, have come forward if the proposed tax bill passes. Their efforts saved the Washington Capitals, a team that is on its way to winning the Stanley Cup, for the Washington community. Those of you who are familiar with the efforts of those folks who are trying to bring baseball back to Washington after 14 long years of no baseball in this city know how hard it is to bring a major league franchise back, once the city has lost it.

Treasury says that this proposed tax bill would mean that prices on tickets to sporting events would go down. That is absolutely 100 percent wrong. Ticket prices will go up and will go up substantially. Costs are continuing to rise. If anybody here can tell me of any professional athlete who would call up and say he is prepared to take a cut in his salary, I would be happy to hear it. Obviously, that would not happen. With costs rising and revenue decreasing, ticket prices have to rise and rise substantially. The only way ticket prices can go down, as my good friend, Bill Miller, the former Secretary of Treasury has said to me, he said: "Abe, the only way ticket prices can go down is that they will go down, all the way down. Ticket prices will be zero. The only problem is there won't be any teams to watch. They will be broken, long gone."

Point No. 2, how this proposed legislation affects special seating, sky suites, and the future of arena construction in the United States. In 1972, when I determined the build the Capital Centre with private funds, with my own money privately financed, I found that the numbers did not work. The economics just did not work. I traveled around the country, studied all the arenas in the country, and realized that if I would add special seating or sky suites, then the numbers possibly could work. I tore up the plans and redid the plans and added the sky suites and added an additional—in excess of $1 million in revenue flow. With that, I was able to finance the Capital Centre and build the Capital Centre. If the proposed tax bill were on the books at that time, there would be no Capital Centre here today. There would be no basketball team. There would be no hockey team. And Washington would still be a minor league city. And incidentally, the Capital Centre means 1,100 jobs. We have paid over $22 million in taxes to Prince George's County, and we have been responsible for over $115 million in business in the county alone.

Point No. 3, Treasury says that this bill is revenue neutral. Dr. Shils has made it clear that with the complete reduction in ticket sales and the loss of revenue that has been stated earlier, at least $1 to $1.7 billion would be lost in revenue. It is certainly not revenue neutral. Thank you, sir.

The CHAIRMAN. Thank you, Mr. Pollin. I see in the audience my old friend, Birch Bayh, who I have shared many happy battles with. Birch, it is good to see you. Mr. Hochberg.

[The prepared written statements of Mr. Pollin and the National Football League follow:]

STATEMENT OF ABE POLLIN
CHAIRMAN AND PRINCIPAL OWNER,
NHL WASHINGTON CAPITALS,
NBA WASHINGTON BULLETS
AND CAPITAL CENTRE

in appearance before

THE COMMITTEE ON FINANCE,
UNITED STATES SENATE
ON
SPORTS AND THE ENTERTAINMENT DEDUCTION

October 4, 1985

TO MEMBERS OF THE FINANCE COMMITTEE OF THE UNITED STATE SENATE:

I come to you as the principal owner of the Washington Capitals, the Washington Bullets and the Capital Centre. For your convenience I am appearing on behalf of the NBA and the NHL. However, as permitted by your rules, each of the major sports will be filing its own separate position paper with additional data for your information and Major League Baseball will be testifying as well.

THE WASHINGTON EXPERIENCE

As many of you know, the struggle to keep the Bullets and the Capitals alive and to maintain the Capital Centre as a viable structure in the face of repeated losses has been a difficult one. It took a major effort and the strongest support of the business community to enable the Washington Bullets, the the Washington Capitals and the Capital Centre to survive. In the case of the Caps, as part of saving the franchise for Washington, D.C. in 1982, business bought more than 6,000 season tickets and produced sell-outs for the first 10 games. If the President's proposal to disallow the deduction for tickets to sporting events had been law, this effort would have failed, and the Capitals would be gone. If this provision were to become law now, the viability of these essential franchises in the Washington economy, and the jobs and businesses which depend upon them, would be seriously threatened.

I have attached to this statement as Exhibit B a copy of a letter summarizing the analysis made by Alexander Grant & Co., Certified Public Accountants. The study demonstrates the essential character of the sports franchises to the Capital Centre, and the importance of the Capital Centre to Prince George County and the Washington Community:

Over $22,000,000 in county taxes,
Over $115,000,000 in expenditures,
Over 1,100 jobs.

If the proposal to disallow the deduction of tickets in the Capital Centre were enacted all of these benefits would be threatened.

Impact on the U.S. Economy

In January of this year, Dr. Edward B. Shils of the University of Pennsylvania's Wharton School did a study (for purposes unrelated to taxes) of the contributions of the major sports to the Philadelphia economy. Dr. Shils found that the direct contribution to the economy of the City of Philadelphia from professional sports teams was over $200 million annually, and when indirect contributions were added, such as the 3,000 independent vendors who sell various goods to the teams, (and a conservative multiplier of 1.7 is applied), the overall figure increased to $343 million. When the entire metropolitan area is included, the total of direct and indirect benefits grows to $574,612,733. (See Tables 2 (page 6) and 3 (page 8) of the attached Exhibit A.)

Faced with the President's tax proposal, the major sports asked Dr. Shils to make a further study of the effect the President's proposal to bar the deductibility of tickets would have on his figures with respect to the economy of Philadelphia and the country as a whole. Based on a survey of a substantial, representative sample of large and small businesses (more than 1,100 responses at September 23, 1985), Dr. Shils' findings may be summarized as follows:

If the President's provision were enacted:

1. Only 22.9% of businesses which have traditionally entertained would continue to purchase sports tickets without change.

2. For the remainder, there is "a discontinuance rate" (on the average) under which business tickets purchased would be reduced by 56.9%.

3. This would result in a loss of Gross National

Product to the Philadelphia area of $156,000,000 per year.

4. Using the method of extrapolation, Dr. Shils then computed the estimated loss of gross national product arising from the elimination of the deduction in the 31 U.S. regions of major league sports franchises at 3,946 billion dollars.

The proposal will produce a heavy loss of federal tax revenue.

A primary objective of the tax reform bill is 'revenue neutrality'. The Treasury conceded that the ticket proposal was not designed as a revenue raiser and the projection of additional revenue which it would theoretically produce was so insignificant that the Treasury Department did not provide specific estimates for it. We now know that the proposal would be a heavy revenue loser. To quote the findings of Dr. Shils of September 25, 1985:

> "I believe that it is extremely important that members of Congress understand that the U.S. Treasury will lose in 1986 approximately $1 billion to $1.7 billion in tax collections, based only on football, baseball, basketball and hockey; and possibly lose as much as $4.5 billion when all professional and amateur sports of every variety are included." (p. 3)

Impact on Professional Sports

Suppose we move from an examination of the impact of the proposed ticket disallowance on the economy as a whole to look at its effect on individual leagues and franchises. The data developed by the major sports themselves is consistent with Dr. Shils' findings. Thus, the NBA reported that approximately 51% of its gate was attributable to business purchases, the NHL more than 60% and Baseball approximately 46%. In terms of financial losses, the NBA shows 12 out of 23 clubs losing money in the last reporting year for an aggregate loss of $17,000,000, averaging approximately $1.4 million per losing club. The NHL for its last year shows 10 out of 14 clubs losing money for an aggregate loss of $11,000,000. The NHL made a conservative assumption that 50% of its gate arose from business ticket purchases and that of this 50% about only one-half would cancel and could not be replaced by other purchasers. The consequence of such cancellations would be an additional loss of approximately $1,800,000 per U.S. club. If that were the case, 13 out of 14 NHL clubs in the U.S. would show very substantial losses and only one club would show a profit. It is not surprising that the responses of such clubs as Detroit, my own (Washington) and Minnesota to the proposed legislation are 'disastrous', 'cease operation', . . . 'out of business' . . . . There could only be one result if the President's proposal were adopted: 'marginal franchises' and clubs in smaller markets like Minnesota, Buffalo, Portland and yes, Washington, could not survive.

Economic Impact on Municipalities and Building Owners

As the owner and operator of the Capital Centre, the leading entertainment facility in the Washington area, I know how essential the income from sports franchises is to the viability of an arena. Without the Bullets and Caps, the Capital Centre would have to close its doors. In our building the tickets sold for Bullets and Capitals games provide more than 30% of the total revenue. When advertising, concessions and related income are taken into account, the percentage is much larger. In one typical city arena, for example, rent and other payments provided by the professional hockey franchise alone contributed during the season 1983-84 more than 68% of the building's revenue and reimbursed the city for more than 75.5% of the cost of operations of the facility.

It may be that few, if any, new sports facilities would be constructed if the proposed disallowance were enacted. We could not have built the Capital Centre nor maintained the franchises here without the cash flow from the sports teams' rent and from the payments for special seating. The proposal in the President's bill would imperil and, indeed, in some cases destroy entirely business financing of projects for the construction of sky boxes and similar structures which would involve millions of dollars of investment and contribute substantially to the economies and vitality of cities throughout the country. In the case of the Philadelphia Spectrum, the proposal to eliminate the ticket deduction has already called a halt to an expenditure of $25 million for boxes that would benefit all citizens of the Philadelphia community and similar projects of the Minnesota

North Stars and other members of the NHL are threatened. The effort to retain the baseball Phillies and the football Eagles for the City of Philadelphia, and to prevent their move to other territories, was in large measure dependent on the corporate purchase of boxes and related additions for Philadelphia's Veterans' Stadium.

The inexorable impact of the proposed provision would further reduce the revenues received by the municipal arenas and stadia (the revenues are in many cases already inadequate) and the ability of many municipalities to meet debt service requirements on the bonds issued to pay for such investments will be seriously diminished. The ultimate result may be an increase in local taxes to compensate for the loss of rent and taxes payable by the professional sports team. Such a scenario would be an ironic and unanticipated consequence: the business purchaser would be denied his deduction, with the cost of that denial billed to the so-called 'ordinary taxpayer', who may not even be attending the sporting event or utilizing the sports arena at all.

Damages to Related Industries and Their Employees

When a sports fan attends an NHL or other professional game, he does not just buy a ticket: he pays for transportation to the city and to and from the arena; he buys food and drink before, during or after the game; he parks his car in a municipal or other parking lot; he buys programs and novelties for his wife, his children and himself; and he frequently stays in a local hotel overnight. Each of the industries that supplies these products or services to sports fans would be seriously damaged by the proposed legislation. For example, there will be approximately 6,400,000 paid admissions to NHL arenas in the U.S. during the 1984-85 season. The average purchase for food and drink per person during this year is approximately $3.40 per ticket sold. On this basis sales of food and drink in U.S. NHL arenas during the 1984-85 season will be in excess of $21,760,000. If proposed legislation had the effect, as is possible, of eliminating the business purchase of tickets entirely, the sales of food and drink in the U.S. arenas could be reduced by $10,880,000. If only one out of two business purchasers cancelled, the loss would still be more than $5,440,000 for hockey events alone. This loss of revenue multiplied by the number of fans attending baseball, basketball, football and other sports events, would be a devastating loss to the purveyors of food and drink and would mean a concomitant loss in wages and employment for the vendors, ticket-takers, the ushers, the hotel personnel, truck drivers and all of the others who are involved in supplying products and services to the professional sports industry.

In the Wharton report of September 25, 1985 Table 1E (page 5 of the Tables) Dr. Shils computes the reduction in direct payments other than ticket purchases made by spectators, fans and visiting teams in the Philadelphia area at approximately $20,900,000. Using Dr. Shils' multiplier of 1.7 this would show a negative impact in the Philadelphia market on the food, entertainment, hotel and other industries dependent upon or relying on sports, which would be caused if the disallowance provision were enacted, of more than $35,000,000 per year. Applied to the 31 major league regions used by Dr. Shils (Table 7) this means that the annual loss of revenues to their industries, and their vendors and employees would be more than $886,000,000 per year.

It is important to understand that the employees who would be primarily affected by this loss of business would be in large part minority persons who are entering their first level of employment: the worker in the meat processing plant--the man that makes the hot dogs; the car parker; the usher; the beer vendor, etc.--they are the people who will be hurt the most.

Increased Ticket Cost for Fans

Could the loss of business purchases be recouped? The recent baseball strike demonstrates how difficult, if not impossible, it is to 'roll back' player salaries. For the most part, rent and other major costs of operation in a sports arena are 'fixed' expenses, the largest portion of which is player costs. But in the current environment, where long term collective bargaining agreements are in effect, players perform under 'no cut' contracts or their equivalent (as in the NHL) and in an atmosphere of full or modified 'free agency', the prospect of reducing player salaries and thereby recouping the revenue that would be lost under the bill is non-existent.

Nor could the loss of gate receipts, estimated in the NHL at $1,800,000 per club, for example, be recouped through television. Hockey does not produce the large network dollars which may be available for other major sports; and these other major leagues are already finding resistance to further increases in their network dollars and consumption of a larger and larger proportion of those dollars in collectively bargained player benefits. The only possible way of recoupment, therefore, would be through price increases. A study made by Ernst & Whinney, for example, for the NBA found that a 60% decrease in business revenue would require a ticket price increase of approximately 37% to recapture those dollars. In order to cover the projected loss in the NHL of $1,800,000 per team, the average U.S. ticket price would have to go from $12.64 to $17.00 ($34.00 for a pair) and $1,360 for a pair of season tickets--a price obviously beyond the means of the worker and the 'ordinary fan' (who may be a small business man) which the Report assumes that proposal would benefit. Marginal franchises and those in small cities could not stand such a price increase, and would have to move or die.

In those arenas now selling out where price increases might be feasible to cover the projected loss of revenue, the proposal would have an effect contrary to what was suggested by the Treasury: the 'ordinary fan' would find his ticket price driven up by the tax provision--not cut down.

"Unfairness" to Everybody

We have demonstrated that the proposal to disallow the deduction for the cost of tickets to sporting events will be devastating to the financial survival of professional sports; will produce economic injury to the related industries and employees which depend on sports for their survival; will place increased burden on the ordinary fan and ordinary taxpayer in the form of higher ticket costs and additional taxes to support municipally financed sports facilities; and will produce a heavy loss in federal tax revenue.

The Treasury acknowledged much of this. Why, therefore, is this provision in the President's bill? The provision was drafted on the assumption that the public 'perceives' the current deduction as unfair: 'Joe Six Pack' is pictured as snarling at his neighbor sitting in a tax deductible seat.

I must say that in all my years in professional sports I have never heard a single complaint on this score, and John Ziegler, the President of the NHL, tells me that the NHL in all the years since 1977 that he has been the President of the league, the NHL has not received a single telephone call, telegram, letter or other complaint by any fan as to the deductibility of the cost of any ticket or the use of any tax advantage.

Our experience and empirical data demonstrate that the Treasury's assumption is mistaken. The unfairness that the Treasury Department perceives simply does not exist in the sports world. Fans demand and appreciate business involvement; for example, when corporations spend great sums in the purchase of tickets to produce a sell-out and avoid a TV blackout, the fans don't complain, they cheer the business that responds. When the survival of the Washington Capitals and the Capital Centre was threatened, the fans expected business to come forward with the purchase of thousands of season tickets necessary to keep the team here and the building open, and the Washington area sports fans applauded this effort. The typical business buyer of sports tickets is a small businessman, a retailer, a wholesaler, a manufacturer's representative, a salesman or a professional. This view is supported by a study conducted by the Minnesota North Stars of business season ticket holders which found two-thirds of those sampled were either individual proprietors or owners of small businesses (less than 250 employees). These estimates were confirmed by other clubs conducting similar reviews of business ticket purchasers. Tickets owned by a business are used for customers, suppliers, employees, employees of suppliers, etc. and not simply by owners; so that the tickets and benefits are spread through all levels of society.

Contrary to the suggestion in the Treasury report, the President's proposal will not produce 'fairness'. It will be unfair to everybody--the fans will have to pay higher ticket prices, some will lose their teams; the taxpayers will have to cover the losses of municipal buildings; the citizens and workers in the community will lose jobs and income when the sports franchises are damaged or moved.

Summary

The entertainment deduction is not an essential element of tax reform. By its own admission (in conference with the heads of the major sports), the Treasury does not consider even its projections of the revenue impact of the provision significant. The Shils report (Exhibit A) shows the provision could produce a loss of between a billion and 1.7 billion dollars of tax revenue in 1986. Other tax reform proposals--Kemp/Kasten and Bradley/Gephart--recognize the validity, sense and equity of the regular practice of doing business in this area and reject the Treasury's attempt to prevent these legitimate business deductions.

We support the objectives of tax reform: but the announced objectives of the plan presented by the Treasury include revenue neutrality, fairness and avoidance of economic disruption and hardship. The proposal to disallow this deduction fails on all counts: it will not raise even the small revenue projected but produce substantial loss of revenue; it discriminates against small businessmen and will be perceived as unfair by them and by fans everywhere; and, weighed against the drastic economic impact it would produce on sports and the industries and employees that depend upon sports for livelihood, the only choice is to strike the provision from the bill.

SUMMARY STATEMENT OF THE NATIONAL FOOTBALL LEAGUE ON THE PRESIDENT'S TAX PROPOSAL

October 4, 1985

The National Football League and its 28 member clubs oppose the elimination of the entertainment deduction for tickets to sports events. This proposal would have an adverse impact not only upon the NFL member clubs but also upon stadium authorities, local governments, urban economies and sports fans throughout the nation.

The NFL has long enjoyed a close association with countless local businesses, which serve and support it, and local governments, which receive tax and other revenue because of league activity, in the large and mid-sized communities where its clubs are located. The NFL entertainment product has enhanced the promotional and sales activities of businesses of every type and contributed to the financial stability of local governments and urban economies in every section of this country. The elimination of the business deduction for sports tickets would unnecessarily limit the contributions professional sports make to business development and urban economic opportunity at a time when they are needed most.

With 28 teams the NFL is the most widely available professional sports team entertainment. Consequentally, the NFL has forged partnerships with the public in building and improving stadiums throughout the country. The amortiziation of the debt remaining on many stadium construction projects is large and dependent upon the continued financial health of professional sports. An integral part of the economic structure of professional football is the deductibility of business entertainment ticket expenses. By denying the deductibility of these expenses, Congress would jeopardize the financial future of these projects which were commenced with the assumption of the continued availability of this deduction. As a result, the adverse impact of this proposal would be widespread and put further pressure on already limited public funds.

The NFL also disagrees with the Treasury Department's projection that this proposal will result in any increase in federal revenues. In a study jointly commissioned by Major League Baseball, the National Hockey League, the National Basketball Association, NASCAR and the NFL, Dr. Edward Shils of the Wharton School of Business at the University of Pennsylvania concluded that the U.S. Treasury will lose in 1986 approximately $1.0 billion to $1.7 billion based only on the projected loss of revenue associated with the impact on football, baseball, basketball and hockey. That sum could increase to as much as $2.5 billion when all professional and amateur sports are included in the analysis.

Dr. Shils' analysis points to the strong and widespread connection professional sports have to local businesses in the major urban areas in the United States. Professional sports teams may be small businesses, but they are a part of a network of businesses whose impact on sensitive urban economics is profound. These businesses rely upon professional sports to a degree not recognized by the Treasury Department in its analysis of the President's tax proposal. Many of those businesses will suffer to the same or even to a greater degree than professional sports clubs if this proposal is adopted.

Given the demonstrable adverse federal and local government revenue impact, the widespread disruption to sports communities and urban economies and the expected harm to professional sports entertainment in general, it is not surprising that other major tax proposals by Senator Bradley and Congressman Gephardt and Senator Kasten and Congressman Kemp preserve the deductibility of entertainment expenses.

The NFL is proud of its record of growth and achievement through the years. This has been possible because of the strong and consistent support of the public. As the Justice Department recently noted in Congressional testimony, "Professional team sports in this country represent a triumph of capitalism." We feel no reasonable tax policy justification nor broader public policy imperative dictates the fundamental change in the professional sports sector of the economy which will result if the entertainment expense proposal is adopted. The NFL along with the other professional team sports leagues in the United States urge its rejection.

STATEMENT OF PHILLIP R. HOCHBERG, ESQ., ATTORNEY, BARAFF, KOERNER, OLENDER & HOCHBERG, WASHINGTON, DC; ON BEHALF OF THE NATIONAL ASSOCIATION OF COLLEGIATE DIRECTORS OF ATHLETICS

Mr. HOCHBERG. Thank you, Mr. Chairman. Thank you for the opportunity to speak this morning. My name is Phillip Hochberg, and I am here today representing the National Association of Collegiate Directors of Athletics [NACDA]. I can only assume that our scheduled witness, Dick Dull, is hung up perhaps on the Beltway somewhere between here and the University of Maryland. To put it succinctly, Mr. Chairman, we view the proposed changes in Treasury II with considerable alarm. One might say facetiously that the more recent proposal announced by the House Ways and Means Committee is only half as bad since it will allow a 50-percent deduction, but right there is where the humor ends. For the member schools of NACDA, the adoption of either proposal would be a disaster. College sports would be especially hard hit by its effects. Recognize, first of all, the structure of collegiate sports. At virtually all institutions, you have but two revenue-generating sports, football and basketball. These two pay for every other intercollegiate form of competition. The impact of revenue reduction, and that is exactly what this would amount to, would be felt at universities across the Nation on track, wrestling, lacrosse, tennis, cross country, soccer—you name it.

The revenue shortfall would be felt across the entire men's athletic program. And for women's athletics, and we want to make a special mention of them, the results would be equally grave. Title IX participation has become a source of pride for many schools. Participation in women's athletics has grown geometrically in the past 10 years. We don't want to preside at the demise of women's athletics, but the ability to support and fund women's athletics would be devastated. Mr. Chairman, for the colleges the injury would not stop there. The effort of businesses in our ticket sales has a tremendous spillover impact on other aspects of university life beyond game-day Saturday. Major institutions depend on our athletic programs to help generate support for scholarships and indeed for building programs. Many universities see the construction of additions to their stadiums, such as skyboxes, to be long-term investments in capital plant and in community involvement. The adoption of this proposal would stop those plans dead in their tracks. There well may be a perception that the colleges really don't have an interest in this since, after all, tickets are all purchased by loyal grads of Ol' Siwash. But surveys done by the College Athletic Business Managers Association show 35 to 40 percent of all tickets are purchased by businesses. And might I remind you that a college team doesn't have the luxury of seeking an alternative and new geographic area. If ticket sales disappear, the teams, the institutions, and the communities will suffer. There is one potential source to remedy these injuries. We could go seek tax dollars. Robbing Peter to pay Paul has never made much sense, and it certainly doesn't in this case. Mr. Chairman and members of the committee, you will hear other reasons why these tax proposals do not make economic sense—a decrease in tax revenue, an increase in ticket prices, economic injury to the communities, injury to municipally financed sports facilities, injuries to employees. Others are more capable than I am of speaking to these, but as a representative of collegiate athletics today, I simply urge you to recognize that our programs are more vulnerable to what we feel is inappropriate and harmful legislation. Thank you, sir.

The CHAIRMAN. Thank you. Mr. Noll.

[The prepared written statement of Mr. Dull follows:]

REMARKS OF
RICHARD DULL, ATHLETIC DIRECTOR
UNIVERSITY OF MARYLAND
REPRESENTING
NATIONAL ASS'N OF COLLEGIATE DIRECTORS OF ATHLETICS (NACDA)
BEFORE THE
SENATE FINANCE COMMITTEE

OCTOBER 4, 1985

Thank you, Mr. Chairman, for the opportunity to speak this morning. My name is Richard Dull; I am Athletic Director at the University of Maryland and I am here today representing the National Association of Collegiate Directors of Athletics (NACDA).

To put it succinctly, we view the proposed changes in Treasury II with considerable alarm. One might say facetiously that the more recent proposal announced by the House Ways and Means Committee is only half as bad, since it would allow a 50% deduction. But right there is where the humor ends.

For the member schools of NACDA, the adoption of either proposal would be a disaster. College sports would be especially hard-hit by the effects. Recognize first of all, the structure of collegiate sports: At virtually all institutions, you have but two revenue-generating sports -- football and basketball. These two pay for every other intercollegiate form of competition. The impact of revenue reduction -- and that is exactly what this would amount to -- would be felt at the University of Maryland on track, wrestling, lacrosse, tennis, cross-country, soccer; you name it. The revenue shortfall would be felt across the entire men's athletic program.

For women's athletics -- and I want to make a special mention of them -- the results would be equally grave. Title IX participation has become a source of pride for us and for many other schools. Participation in women's athletics has grown geometrically in the past ten years. I don't want to preside at its demise, but the ability to support and fund women's athletics would be devastated.

Mr. Chairman, for the colleges, the injury would not stop there. The effort of businesses in our ticket sales has a tremendous spillover impact on other aspects of university life beyond Game-Day Saturday. Major institutions depend on our athletic programs to help generate support for scholarships and indeed for building programs. Many universities see the construction of additions to their stadiums -- such as sky-boxes -- to be long-term investments in capital plant and in community involvement. The adoption of this proposal would stop those plans dead in their tracks.

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There is one potential source to remedy these injuries: We can go seek tax dollars. But robbing Peter to pay Paul has never made much sense to me and it certainly doesn't in this case.

Mr. Chairman and Members of the Committee, you will hear other reasons why these tax proposals do not make economic sense -- a decrease in tax revenue; an increase in ticket prices; economic injury to the communities; injury to municipally-financed sports facilities; injuries to employees. Others are more capable that I am of speaking to those. But as a representative of collegiate athletics, I simply urge you to recognize that our programs are more vulnerable to what we feel is inappropriate and harmful legislation.

Thank you.

STATEMENT OF JOSEPH N. NOLL, PRESIDENT, NATIONAL CLUB ASSOCIATION, MADISON, WI

Mr. Noll. Thank you, Mr. Chairman. I am Joseph Noll. I live in Madison, WI, and I am president of the National Club Association, which represents the legal and legislative interests of private social athletic and recreational clubs. I also represent the several million members of these clubs. We appreciate the opportunity to testify. We, too, are strongly opposed to the proposals now before Congress. The majority of the club members—nearly all of them—are the people who have been the successful achievers in our free enterprise system, whether in business or in the professions. I think occasionally we become a little put out by the reference to the idle rich in the clubs and the privileged and that sort of thing. I think I represent among the hardest working people in this country. Many of them are dependent upon establishing personal relationships in order to do business and gain the trust of their clients and customers. Payment of club dues, in fact, is no more nor less than rent paid to obtain use of a club facility, just as one pays rent for office space or use of a meeting room at a hotel or restaurant. Experience has convinced these people that the ambience that most clubs give them on a one-to-one basis is conducive to establishing that necessary public trust, or personal trust; and it works. We, too, feel that the Treasury estimates are misleading, that the proposals would have a negative effect on Federal revenue. Quickly, and for example, of the 5,500 private clubs in the survey we did of some of them, we estimate that 80,000 jobs would be lost because of the decline of revenue to these clubs. That would mean, by our calculation, a shortfall of $200 million in payroll taxes alone for 1 year, not counting greater unemployment and welfare costs. Tens of thousands of part-time employees in addition would be affected. I think we must understand that the workers we are talking about here are entry-level type workers. They are relatively marginal. They have limited skills. The skills they have have been what they learned at their occupation, and they may face prolonged unemployment. The question of abuse always comes up, and I agree with those who spoke before on it. Relative to club dues, the deduction requirements are very stringent and very tough under the present law. You must use your club for at least 50 percent of the time to get any deduction, and the actual business use must be documented. There is constant talk of abuse, but there is no evidence or documentation to back it up by the Treasury or anyone else. If there is abuse, and we are going to correct it by eliminating these deductions, I think this is analogous to restricting the use of automobiles to everyone because there are a few drunken drivers. That just doesn't make any sense to me. We seem to be operating here on perception as to what people think, not what is the fact. I have some problem with that. Mr. Chairman, I would like to directly answer your question, if I may, from a different and colloquial perspective that you asked of the other panel. I have spent most of my life in manufacturing, most of it in the machine tool industry which has very serious ups and downs, as you may be aware.

I was chief executive officer for a machine tool company for many years. We were in one of our downs, and a down in the machine tool industry is about a 50 percent reduction in business—it gets very serious, a lot of people laid off, short hours. I was walking through the plant one day, and the union president stopped me; and he said, "Mr. Noll, isn't there anything we can do about getting more business in for the plant?" I said: "I sure wish I knew what to do. Have you any suggestions?" He said: "Well, some of us were talking, and we see that when you go out for a week, you seem to bring business back. The salesmen don't get it, but you do." I said: "Well, that is very flattering. Sometimes they save the orders for me to pick up." But I think what I am getting at here is that I think we deprecate the American worker when we think he doesn't understand how business is obtained and how business expenses and entertainment expenses are necessary to get that business. I think if you were to survey the average American worker and ask him what his boss' No. 1 job is, I think he would tell you "to get more business for the company," because this so directly relates to his personal economic well-being. He may not think so of the boss at the next-door plant, but he sure thinks it about his own boss; and I suggest to you that the answer to the question you asked is to tell the employee "that is where your job comes from." I think it is as simple as that. We are a marketing nation, a free enterprise system; and it dictates that, without the necessary expenses and attitudes and effort that is put into marketing, the chances are we could not sustain our employment at anywhere close to the level we have it today. I am concerned about what appears to be governmental intrusion into the determination as to what our legitimate marketing expenses are. I just don't think that this is something that is for them to get involved in unless they decide that there are no marketing expenses and there are no expenses at all that are legitimate and to go to a gross income tax. Just let me say in conclusion that we are opposed to what we have read in the paper about the new proposals from the House Ways and Means Committee. We are opposed in principle, and we estimate that perhaps we would have an impact about two-thirds as great as the original proposal. Thank you very much, sir.

The CHAIRMAN. Thank you very much, sir. Mr. Seidler.

[The prepared written statement of Mr. Noll follows:]

COMMENTS
OF
THE NATIONAL CLUB ASSOCIATION
TO THE
COMMITTEE ON FINANCE
OPPOSING PROPOSED CHANGES IN
THE TAX DEDUCTIBILITY
OF
CLUB DUES AND BUSINESS MEALS

OCTOBER 4, 1985

The National Club Association (NCA) respectfully submits these comments to the Committee on Finance in opposition to proposals now under consideration that would eliminate the deductibility of club dues and other business "entertainment" expenses, and would restrict the deductibility of business meals.

NCA is the national trade association that represents the legal and legislative interests of private social, athletic, and recreational clubs. Representatives of the organized golf community, including the Club Managers Association of America, the Professional Golfers' Association of America, the PGA Tour, and the Ladies Professional Golfers Association, endorse and support these comments.

We believe these proposals are unwarranted and unfair. They would inflict severe economic hardship on the nation's 5,500 clubs and their employees. They would deny important business opportunities to many who rely on clubs for critical marketing activities. And they would set a precedent of unjustified government interference in private business decisions, while placing us on the road towards the taxation of gross rather than net income.

Private clubs are neutral settings which their members may choose to use for a variety of social, family, recreational, and business purposes. When a member chooses to use a club for business purposes, a tax deduction should be allowed for that portion of dues which has made such business use possible. The tax law properly recognizes that the individual member is entitled to a deduction of expenses for activities which promote or enhance business, including club dues. (It should be noted that a club does not control the use made of it by its members, nor does it benefit directly from the tax deductions for club use claimed by its members.)

That portion of club dues which is deductible as a business expense is the same as the rent paid for use of office or factory space, or for use of a restaurant or hotel meeting room. As with other such rent, club dues simply entitles the business person to the use of the facility for a prescribed period of time. When the club or other facility is used for a business purpose, the rent should be fully deductible as a business expense.

The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity (May, 1985) would "completely eliminate deductions for entertainment expenses such as tickets to professional sporting events, tickets to the theater, the cost of fishing trips, and country club dues." (page 78) (Emphasis added). In addition, it is proposed that business meal deductions be limited to $25 per person per meal plus 50% of any amount above that $25.

It should be noted that even though the proposals mention only "country club" dues, all club dues would be equally affected. This would even include the deductibility of dues paid to service clubs such as Kiwanis, Zonta, Business and Professional Women's Clubs, Rotary, or Lions, as well as dues paid to fraternal or sororal organizations, such as the Benevolent and Protective Order of Elks and the Loyal Order of Moose, provided those dues meet the tests for such deductions.

By predicating disallowance on the allegation of tax abuse, enactment of these proposals would mean that such expenditures could no longer be deducted even though the taxpayer saw it as in his best interest to invest his capital in such a manner. In fact, such deductions would be disallowed even if the taxpayer could document beyond question a direct and significant connection between his or her business success and those expenses. Even though a taxpayer could establish that ten new clients were acquired in a given month immediately after being entertained by the taxpayer at his or her club, none of the cost of membership in that club would qualify as a deductible expense. We believe that the disallowance of a tax deduction for such a legitimate, documented business expense would be a radical and unprecedented departure in our federal tax code. It suggests that government is about to expand significantly its involvement in the private investment and marketing decisions of individual taxpayers. Government would, under these proposals, be substituting its judgment for that of the individual entrepreneur in determining which business expenses are appropriate (i.e. deductible) and which are not.

Three reasons are cited in support of these proposed tax deduction changes. First, it is alleged that there is a perception that there are "extreme abuses of these deductions... (although) such abuses may be limited to a relatively small number of taxpayers... they nevertheless undermine the public trust that is essential..." (Tax Proposals, page 76). Second, it is contended that these deductions unfairly benefit a "limited class of taxpayers." This "class" apparently consists of business persons, professionals, sales personnel, and entrepreneurs who find such expenditures to be an essential marketing expense. According to the Tax Proposals, "Lunches are deductibie for a business person who eats with clients at an elegant restaurant, but not for a plumber who eats with other workers at the construction site." (page 75). Finally, it is said that there is a "large personal component" in such deductible activities which makes these proposed changes necessary. (Tax Proposals, page 78). This apparently means that because taxpayers may derive some personal benefit or enjoyment from such activities, the costs should not be deductible.

In the balance of these comments we shall explain why the rationale for these proposals is spurious, invalid, and dangerous. We shall show that the present law concerning tax deductions for club dues and business meals is fair and reasonable and should not be changed. We will also demonstrate that these proposed changes would be economically disastrous for clubs and their employees. We shall first examine the severe economic damage that would result.

I. THESE PROPOSALS WOULD INFLICT GREAT ECONOMIC LOSSES ON CLUB EMPLOYEES AND CLUBS, AS WELL AS ON OTHER SECTORS OF THE ECONOMY, WHICH WOULD NEGATE THE PROJECTED TAX REVENUE GAINS.

On the basis of a recent survey of member clubs of the National Club Association, we estimate that severe economic hardship would be the direct result of these proposed changes in the deductibility of club dues and business meals. While the worst direct impact would fall on city clubs, the proposals would also be highly detrimental to golf clubs.

If the deductibility of club dues is eliminated, we estimate the average city club revenue loss would be 36 percent. A startling 52 percent reduction in city club full-time jobs is projected.

For golf clubs, removal of the club dues deduction would result in an average revenue loss of 18 percent, and a job loss of 19 percent.

The singular impact on clubs of the proposed restrictions on business meal deductions would be less, but still significant. City clubs would lose 20 percent of their revenue, and have to lay off 24 percent of their full-time workers. Golf clubs would see a six percent revenue decline and lose seven percent of their full-time employees.

The magnitude of the employment impact in the club industry is best indicated by the actual number of jobs that would be lost.

There are approximately 4,500 golf clubs and 1,000 city clubs in this country. NCA figures show that the average city club now has 72 full-time employees and the average golf club 55 employees. This means a grand total of 72,000 city club employees and 247,500 golf club employees. Summertime employment, particularly in golf clubs, is significantly higher.

The job loss impact of the removal of dues deductions alone would therefore be 37,000 full-time city club jobs and 44,000 full-time golf club jobs, or a total of 81,000 jobs.

Since the vast majority of these jobs are likely to be entry level, with few transferable skills possessed by current workers, it can be reasonably predicted that those losing such jobs are likely to face some period of unemployment, probably prolonged.

It is instructive to direct attention to the lost income and tax revenue that would also result. Assuming an $8,000 average annual salary in such club jobs, the overall economy would see income decline $648,000,000 from the loss of these 81,000 jobs. On the basis of an average 30% payroll tax, this would mean a total loss of $194,000,000 in payroll taxes.

An independent financial study by the Club Corporation of America (CCA) confirms the enormous economic price that clubs and club employers would have to pay if these proposals are enacted. With 165 clubs, CCA is the largest corporate owner of clubs in the world. After a careful study of its clubs' financial status, CCA has concluded that if these tax deduction changes cause even a ten percent decline in club membership, 61 of the CCA clubs would have to close and 3,700 employees would lose their jobs. If club membership declines 25 percent, 97 CCA clubs would shut down and 5,900 jobs would be lost.

It should be noted that the Tax Proposals estimate a $600,000,000 federal revenue gain to result in the first year from the proposed changes in all business entertainment deductions. It can be seen that the elimination of club dues deductions alone -- without considering the impact of the loss of any other business entertainment deductions -- would negate at least a third of this purported revenue gain.

In addition, the Professional Golfers' Association of America esstimates that an 18 percent decline in golf club revenue as projected would mean a loss of at least 4,500 jobs in the golf operations usually run independently by golf pros at clubs.

These revenue and job loss projections do not include the tertiary impact on suppliers and vendors that serve the club industry. Here the impact would likely be especially great in the golf industry, which supports so many highly specialized equipment manufacturers. The data also does not include the revenue and job losses that would result from an expected substantial decline in corporate sponsorship of golf tournaments, when a substantial portion of such sponsorship expenses (i.e. to entertain customers or clients) could no longer be deducted as business expenses.

There would also be an adverse effect on charitable income. In the past five years, golf tournaments held under the auspices of the PGA Tour have generated $36,173,000 for a wide range of charities. It can be reasonably assumed that a substantial decline in tournament corporate sponsorship would have a direct and significant negative effect on this charity flow. Even if such corporate sponsorship continues, the private golf clubs which host nearly all these professional tournaments would be so weakened by the revenue losses resulting from these tax changes, that the tournaments would inevitably be diminished, thus reducing their appeal and undoubtedly shrinking the resulting charitable income.

Finally, it can be projected that it would be not just clubs and their ancillary suppliers and activities that would suffer. The economic damage could be much more widespread.

It can certainly be assumed that a minimal number of business agreements result from the use of private clubs by their members to entertain or meet potential clients and customers. If one assumes that only ten such agreements result each day from meetings at the typical city club and two per day from meetings at the typical golf club, with the average agreement worth $100,000 and generating or supporting two jobs, this translates for America's 5,500 clubs (4,500 golf clubs and 1,000 city clubs) into over 10,800,000 jobs. Then assume that just five percent of these business agreements will be lost if club expenses are no longer tax deductible and clubs are no longer relied on for business uses. Certainly businessmen will still take clients and customers to dinner, but it is most unlikely they would use to the same extent clubs which require dues, and they would thus not have the opportunity to enjoy the club ambiance that can be so conducive to business discussions and negotiations.

With a five percent loss of those jobs that result from such use of clubs, the result would be a loss to the economy of 540,000 jobs. If these jobs average $25,000 in annual income, there would be a $13.5 billion loss in overall income, which would mean a $4.05 billion loss in payroll taxes just for the Federal government.

Where then would be the economic gain to our nation from this proposed tax "reform?"

II. CLUB DUES AND MEAL EXPENSES SHOULD BE DEDUCTIBLE WHEN USED FOR BUSINESS PURPOSES

Theodore Levitt, renowned professor of marketing at the Harvard Business School, has described the important role of the business meal in his classic study, The Marketing Mode:

> It is so important and so central to the industrial selling process that it ... is taken for granted like oxygen in the air ... [T]he lunchee does not make his buying decision purely on price, specification,

> technical services, or delivery. The lunch exists to help create relationships of personal trust and understanding ... to go beyond the slide rule and the laboratory in getting and cementing sales. ...
>
> Advertising performs much the same function as the business lunch. It creates familiarity. With familiarity is likely to come conviction and trust.

Congress in its wisdom has recognized the economic and entrepreneurial rationale for allowing tax deductions for club dues and meals that can be shown to have a business purpose. In 1978, Congress explicitly reaffirmed the effectiveness of club dues as a legitimately deductible business expense, when it denied the request of then Treasury Secretary Blumenthal to disallow this deduction. For many taxpayers, e.g. for professionals, for salespersons, for entrepreneurs, and many others, the club is an extension of the office and the business meal is simply another opportunity to meet and conduct business. For them the development of a personal relationship between the buyer and seller is critical, and nowhere can this relationship be cultivated better than at a business meal in the quiet, dignified setting of a private club.

Congress has realized that in the real economic world, nothing happens until the sale is made. Nothing is produced, nothing is manufactured, nothing is created unless the sale occurs. No factories open, no offices function unless customers or clients are convinced to buy. Business persons take clients and customers to clubs, as well as to restaurants and to hotel meeting rooms, and meet them over breakfast, lunch, or dinner, because they are convinced this is a wise investment of their time and money. For them this is doing business and it is done only so long as it works. Because it works for them, it should remain just as fully deductible as any other cost of doing business.

For those who make such marketing decisions unwisely, who do not produce more business from their club memberships or business meals, the marketplace is, of course, merciless and unforgiving. In our free enterprise system, that is as it should be. The marketplace is the best judge of which business expenses are appropriate and which are not.

Contrary to the suggestion in the Tax Proposals, these deductions are not available only to a particular class of taxpayers. As with other tax deductions for business expenses they are not based on who claims the deduction, or on where the deductible expense occurs, but on the purpose of the expense. If the plumber mentioned in the Tax Proposals wants to start a business, risk his savings, and incur such business marketing expenses to reach new customers, the deduction is just as available to him as it is to the lawyer or the stockbroker. It may be that the plumber mentioned in the proposals has his present job only because another plumber did strike out on his own.

Club dues are no different from the rental fees paid for office or factory space, or for use of a private meeting room at a hotel or restaurant. Both dues and rent entitle the payor to use those facilities for a designated period of time -- whether several hours in the case of a meeting room, or a month in the case of most club dues --

for whatever private purposes are desired. If those are business purposes, they should clearly be deductible as business expenses.

III. PRESENT DEDUCTION REQUIREMENTS AND ENFORCEMENT ARE FAIR, REASONABLE, AND SUFFICIENT TO PREVENT EXCESSIVE ABUSE.

Current documentation and substantiation requirements are not loosely drawn. Taxpayers claiming deductions for club dues and business meals must show a business purpose, and must keep clear and verifiable records. In light of the strict legal obligations of tax preparers to confirm such substantiation, and in the absence of any contrary documentation, the allegation of excessive tax abuses with regard to these deductions is not credible.

Under present law, a taxpayer seeking to deduct dues paid to a social, athletic or golf club, as well as to other organizations, such civic and service clubs or fraternal and sororal organizations, bears the burden of proving that the club "was used primarily for the furtherance of the taxpayer's trade or business and ... was directly related to the active conduct of such trade or business." (Internal Revenue Code Section 274 (a)(2)(C)). The "primary use test" requires the taxpayer to show that use of the club for business exceeded 50% of the days of actual use.

To establish such business use, the taxpayer must:

> ...substantiate by adequate records or by sufficient evidence corroborating his own

> statement (A) the amount of such expense or other item, (B) the time and place of the... use of the facility..., (C) the business purpose of the expense... and, (D) the business relationship to the taxpayer of persons... using the facility. (IRC Section 274(d)(3)

According to Department of Treasury regulations, the taxpayer must come forward with detailed records as to the number and duration of occasions on which the club was used during the taxable year for business, and the number and duration of occasions on which the club was used during the year for nonbusiness activities. If the taxpayer fails to make this showing, it will be presumed that the club was used primarily for personal purposes and no deduction will be allowed. (See Treas. Regs. Section 1.274-5 (C)(6)(iii)).

In addition to the substantiation requirement of IRC Section 274 and the regulations thereunder, the deduction of club dues must satisfy the test applied to all business deductions, that is, that the expense is "ordinary and necessary" to the conduct of the taxpayer's business. For purposes of club dues, this means that the taxpayer must show that he uses the club for business purposes and that the taxpayer's business has benefitted (or is reasonably expected to benefit) in some specific way beyond the development of goodwill. (IRC Section 162).

Under these rules, if the taxpayer shows that the use of the club is an ordinary and necessary expense of his business, and that he uses the club primarily for business, he may deduct that portion (and only that portion) of his dues which corresponds to the portion of actual club use devoted to business. This percentage will be computed from the detailed records described above.

For business meals to be deductible, the same ordinary and necessary test must be met, and the same substantiation records kept to show that such meals are "directly related" to the taxpayer's business and occur under circumstances that are "conducive to a business discussion." (IRC Section 274 (e)(1)).

We believe these detailed deduction substantiation requirements provide ample authority for the IRS to identify and prevent any misrepresentations or misinterpretations by taxpayers.

Yet, despite the allegations of tax abuses because of such deductions, we have seen no evidence from Treasury or elsewhere documenting such abuse. To our knowledge, there have been no reliable studies or estimates of the rate of taxpayer noncompliance with the present rules and regulations for the deductions of club dues, business meals, or any other aspect of business entertainment.

In the absence of such studies of taxpayer compliance, we strongly suggest that the way to deal with any abuses that may occur is through stricter enforcement of current law. Clearer substantiation rules and procedures may also be advisable. The least rational approach would surely be to accept unproven allegations and insinuations as the basis for completely eliminating legitimate and justifiable deductions.

The Tax Proposals, of course, do not charge actual widespread abuse. In fact, it is conceded that, "Such abuses may be limited to a relatively small number of taxpayers..." (page 76). Rather the argument cleverly presented is that other taxpayers perceive such abuses to be prevalent, and that this undermines public trust in the tax system. Such a speculative argument is, of course, impossible to refute. Of even greater concern, however, is the implication this raises for the formulation of tax policy. Is it now to be determined by plebiscites or public opinion polls, despite contrary facts known to the legislators?

IV. DISALLOWANCE OF THESE DEDUCTIONS WOULD BE UNFAIR AND WOULD SET DANGEROUS PRECEDENTS IN THE TAX LAW.

These proposals would unfairly discriminate against that business person who is uniquely dependent on these kinds of marketing techniques. The entrepreneur or salesman who cannot afford expensive media advertising, the young lawyer trying to build a practice, the new stockbroker working to develop customers, the accountant who needs to meet his clients in a relaxed setting to develop the essential relationship of trust — these are the ones who need and use these marketing approaches most, and who will be discriminated against by these proposals. These are the middle income taxpayers who, if denied such deductions, would be compelled to continue using these marketing tools and bear the entire cost themselves. More affluent taxpayers and large corporations would be able to turn to alternative marketing means which will remain deductible.

As already explained, the economic impact on clubs and their employees will be severe. This industry and other providers of business "entertainment" have been unfairly targeted by these proposals. Expenditures on television and radio commercials, newspaper and magazine advertisements, billboards, and direct mail advertising will remain fully deductible. For certain taxpayers the use of clubs and business meals may be a much more effective and appropriate marketing approach; indeed, it may even be the only marketing technique they can afford. Yet, for them these marketing expenses would not be deductible at all. We do not believe it equitable for the tax code to favor one marketing approach over another. Again, we suggest that such decisions should be left up to the taxpayer, with the marketplace the ultimate judge of whether the taxpayer has invested his marketing resources wisely.

Finally, we suggest that these deduction proposals would establish dangerous precedents in tax law and policy.

The first ill advised precedent would be to substitute the judgment of government for that of the individual taxpayer. As already noted, the marketplace is the best judge of such decisions. Surely our society does not want government to set arbritrary deduction standards for such business decisions. What would be next? Will the government limit tax deductions according to the thickness of the office carpet, or the size of the computer, or the cost of raw materials used? Why not have the government disallow deductions for any products or services which exceed the standards of the General Services Administration?

Another dangerous precedent is the notion that deductions for club dues and business meals should be disallowed because the taxpayer may receive some personal benefit or pleasure from them. As explained above, the taxpayer must substantiate the business purpose of such expenses; no deduction is allowed for that portion of club use which is personal. The most ominous implication of this argument is that the government can somehow recognize and measure whatever personal enjoyment or pleasure may be ascribed. There are many deductible business expenses that arguably include a strong element of personal pleasure, including, for example, the quality of one's office furniture, the artwork on the walls, the view from the window, the design of the employee's cafeteria, etc. The list is endless. What about the personal pleasure of a first class plane ticket on business trips? Is the government about to embark on a pleasure-pain, or rigidly utilitarian approach to taxation? And if we are to tax such personal benefits, should they not be separated from the purely business components of an activity? Will the government tax the 35% of an activity that is personal benefit and allow the 65% balance to be deducted? Will the taxpayer be held to have received imputed taxable income equivalent to the personal benefit portion? How can such lines be rationally drawn?

Finally, it is most troubling to see the government through these proposals depart radically from a system where net income is taxed to move towards a system where gross income is taxed.

The deductions allowed club dues and business meals reflect the basic concept of our tax law that the income tax is levied on net income. This means that the taxpayer should be allowed to reduce the amount on which he is taxed by those expenses incurred in earning that income. As already noted, Congress has clearly understood the wisdom of such deductions in the past, and recognized that to the extent club dues and business meals are "ordinary and necessary" expenses incurred in pursuit of greater income, they should be encouraged by being allowed as deductions.

If we are now about to move away from the concept of taxing only net income, why not indeed go all the way and simply disallow all business expenses? Then we need have no concerns about perceived or actual fairness, determining personal benefits, or eliminating imagined abuses. We respectfully suggest that the eventual, logical consequence of the principles of taxation illustrated by these proposals leads inevitably in that distasteful direction.

STATEMENT OF LEE J. SEIDLER, MEMBER, BOARD OF DIRECTORS, SHUBERT ORGANIZATION, NEW YORK, NY; ON BEHALF OF THE LEAGUE OF AMERICAN THEATRES AND PRODUCERS

Mr. SEIDLER. I am appearing here on behalf of the League of American Theatres and Producers, the association of the owners and operators of legitimate theaters in the United States and the producers of legitimate attractions, such as "Cats," "Annie," "The Whiz," "Amadeus," among others, the segment of the theater known as the tax-paying theater. I am also appearing on behalf of The Shubert Organization, the largest owner and operator of legitimate theaters in the United States. I have used "largest" in speaking of the theater industry, but I think it is important to understand that the theater industry is a small, a tiny industry in the United States. If the entire legitimate theater industry in the United States were combined under one ownership through a single corporation, that entity would not make the Fortune 1000 largest company list. So, we are talking about a small entity.

Secondly, we are talking about a tax-paying entity. Legitimate theater has no tax shelters, no investment tax credits; since our average theater is about 50 years old, we have virtually no depreciation. The Shubert Organization in the last 3 years respectively has paid State and local income taxes equal to 52, 46, and 47 percent of our pretax accounting income in cash. So, we are a tax-paying industry. The only tax losses we have in our industry is when a show opens one night and closes the next one because the critics have bombed the show. And in that case, the loss is entirely cash out of pocket from the investors. So, we are a small business.

We probably have a relatively small proportion of business people attending. Our typical business attendee at the theater is the small manufacturer, perhaps in New York, entertaining a buyer. He takes the buyer to the theater. He knows the next morning whether he gets an order or not. He has direct feedback, far more direct feedback than does our local utility putting an advertisement in the newspaper glorifying its wonderful management.

Treasury has suggested there may be an element of personal pleasure in taking that buyer to the theater. I suggest there may be some, but it dwindles considerably when that man is finishing his 12th hour at work and his third attendance at that same theater with a different buyer. Even though our business percentage is relatively small, our margins are tiny. The margin in legitimate theater is probably about 2.5 percent on the average on gross. If we were to lose, let's say, just 5 percent of our revenues, that would essentially throw the American legitimate theater into a loss position and close up the theater. I think it is important to understand—an analogy was made this morning to an airplane with an empty seat—the costs in the theater are totally fixed. We put a show on; it must run. It must run, no matter how many seats are filled or how many seats are empty. They are so fixed, in fact, that when we keep a theater empty—and right now the theater business is not good; the Shuberts have 8 empty theaters in New York out of the 17 they own—it costs us between $4,000 and $6,000 a week simply to keep the theater empty, for the taxes, maintenance, insurance, and so on on the theater. So, if we get a slight decline, our business will be in great trouble.

Second, it is not just the tax-paying theater that is involved. There is a symbiotic relationship between the tax-paying theater and the thousands of nonprofit theaters around the country. The largest proportion of productions put on by nonprofit theaters that are in every State in the United States come from Broadway, and the largest proportion of productions on Broadway come from the nonprofit theater.

There is a double recycling. For example, the Shubert Organization is owned by the Shubert Foundation, its sole shareholder. The Shubert Foundation gives approximately $2.5 million, which is the major proportion of its profits, back to performing arts groups throughout the United States. It gave 130 grants in 23 States in the United States last year. I would ask you therefore, please, don't erroneously end the deduction that we believe would destroy the only self-sustaining, unsubsidized tax-paying portion of the performing arts in the United States. Thank you.

The CHAIRMAN. Thank you.

[The prepared written statement of Mr. Seidler follows:]

STATEMENT OF LEE J. SEIDLER

MEMBER, BOARD OF DIRECTORS, THE SHUBERT ORGANIZATION

on behalf of

THE LEAGUE OF AMERICAN THEATRES AND PRODUCERS

before the

SENATE FINANCE COMMITTEE

OCTOBER 4, 1985

My name is Lee Seidler. I am appearing on behalf of the League of American Theatres and Producers, an association of the owners and operators of legitimate theatres in the United States and producers of legitimate attractions, such as CATS, ANNIE, THE WIZ, AMADEUS, THE ELEPHANT MAN, among hundreds of others -- a segment of the American theatre known as the taxpaying theatre. We receive no government subsidies nor tax benefits and we pay our full share of local and federal taxes. We manage to survive and compete along with other hardpressed colleagues in the subsidized, non-profit theatre, music, opera and dance.

I also appear on behalf of The Shubert Organization, Inc., the largest owner and operator of legitimate threatres in the United States.

The Shubert Organization pays state and federal income taxes, in cash, in excess of 50% of its pre-tax income. There are no theater tax shelters, except of course, the losses (all cash) that occur when shows close after bad reviews. My joint appearance is in opposition to the elimination or reduction of the tax deduction for theatre tickets purchased for business purposes.

Business entertainment is a normal and traditional aspect of generating taxable income. Business can rarely be developed only by advertising or by posting prices: personal contact is necessary. This contact is often provided by entertainment.

Attending theatre with clients and customers is an ordinary and necessary business expense. These expenditures may be as necessary to the conduct of a profitable business as the purchase of inventory, supplies, utilities or fixed assets.

The success or failure of a business expenditure for entertainment at the theater is easy to ascertain. A manufacturer who takes a buyer to the theater knows the next day whether or not he "got the order". On the other hand, the effectiveness of media advertising is rarely known. Yet media advertising, including ads merely glorifying the company, is unquestioned as a business expense, 100% deductible.

It has been argued by Treasury that there is an element of personal enjoyment in entertaining clients that warrants eliminating or reducing the deduction. Leaving aside the obvious point that business entertainment may be more of a duty than a pleasure, there are substantial personal elements in many business expenditures. Health benefits are totally personal. Office workers are given comfortable chairs, factories are landscaped and well lighted, building exteriors are attractively finished, truck and tractor cabs are air conditioned. Personal elements abound in business expenditures; they do not signal ending deductions.

Existing law places substantial restrictions on the deductibility of business entertainment expenses. There must be a substantial and bona fide discussion of business before, during or after the entertainment and the taxpayer must have a specific expectation of receiving business -- not just goodwill -- from the expenditure. Indeed, it is fair to say that the test of deductibility of a theatre ticket is presently stricter than that for ordinary advertising on television or in a newspaper.

It is obviously difficult to estimate, but we believe that the gross revenues of the legitimate theatre would be materially reduced if the deduction is wrongly removed or reduced. That is, while we believe that most business persons would continue to entertain customers, since it is necessary to their businesses, we would incur some loss of revenue.

Understand that virtually all the costs of a theatrical production and theatre operation are fixed. The show must go on regardless of how many are in the audience. After tax net income margins in the theater are slim, less than five percent on gross. A decline in ticket sales as small as five percent would be fatal to the tenuous economic health of the only unsubsidized, taxpaying performing art form in the United States.

The burden of the proposed elimination or reduction will not fall only on the performing arts. It will be felt in the area that can least afford it, jobs -- jobs in the performing arts and jobs in industries connected with the performing arts -- hotels, restaurants, transportation and tourism.

Disadvantaged people and those who are not already well-educated frequently enter the work force in jobs that do not require special skills -- porters, chambermaids, taxi drivers, parking lot attendants, dishwashers, and waiters. With more manufacturing jobs disappearing, these people cannot find other jobs. In addition, of course, unemployed theatre performers are unlikely to find work elsewhere.

Professional theatre in the United States today is inextricably interconnected in all of its aspects. The Shubert Foundation, the sole shareholder of the Shubert Organization, distributes about $2.5 million annually to about 130 non-profit performing arts groups in 23 states. Plays and musicals that originate in the taxpaying theatre comprise about 70% of the repertory of non-profit theatres. Conversely, plays and musicals which originate in the non-profit theatre find their way into the taxpaying theatre. Some examples are the Pulitzer Prize winning GLENGARRY GLEN ROSS which originated at the Goodman Threatre in Chicago; the Tony Award winning CHILDREN OF A LESSER GOD which originated at the Mark Taper Forum in Los Angeles; the Pulitzer Prize winner play NIGHT MOTHER which originated at the Actor's Theatre in Louisville, Kentucky; the musical QUILTERS which originated at the Denver Performing Arts Center; THE END OF THE WORLD which originated at the Kennedy Center; the play FIREFOX which originated at the Guthrie Theatre in Minneapolis; the musical ANNIE which originated at the Goodspeed Opera House in Connecticut; the Tony Award winning BIG RIVER which originated at the La Jolla Playhouse in California; the Pulitzer Prize-Tony Award winning A CHORUS LINE which originated at the New York Shakespeare Festival. This symbiotic relationship is essential to the economic well-being of both the taxpaying and non-profit theatre as well as to the nurturing and development of the artists and technicians who constantly work in both forums.

Theatre, whether it be presented in taxpaying theatres in New York, Boston, Philadelphia, Washington, D.C., Detroit, Chicago, Dallas, Houston, Los Angeles, San Francisco, and Miami or in the hundreds of non-profit theatres located in almost every city in the United States, is beset with the problems of inflation, fixed costs and competing forms of entertainment. The equivalent of favorable bond issues, investment tax credits, parking and garage facilities, revenue from television and advertising, do not exist for the theatre. Rather, theatre is forced to go it alone, dependent primarily in the case of non-profit theatre, and solely in the case of taxpaying theatre, on the sale of tickets.

Despite these disadvantages, the theatre and the rest of the performing arts constituency in the United States has fulfilled its cultural and educational mission, has stabilized and regenerated neighborhoods in which it functions, and has been an economic resource for the treasuries of the governments of the cities, states and, indeed, the federal government, as well as a lifeline for the restaurants, hotels, transportation businesses and tourist activities whose facilities are used by its patrons.

This performing arts constituency is now faced with a proposal to eliminate or reduce the deductibility of tickets to its performances purchased for legitimate business purposes. This proposal whose serious negative implications cannot be doubted and which are essentially revenue neutral, can only further exacerbate the present fragile existence of the performing arts in the United States. Witness the termination of the Metropolitan Opera tour after one hundred consecutive years, the paucity of touring major plays and musicals, the cut back or abandonment of tours of major ballet companies. The theatre faces rising costs in a business which is entirely hand-crafted and unable to effect improvements in productivity. Nevertheless, we still provide hundreds of thousands of free tickets to students, the elderly and the infirm and cope with the urban environment and the other myriad problems that beset it.

I do not favor deductions that are not warranted. Congress and the Internal Revenue Service have the duty to determine what is a legitimate deduction. What is proposed, however, is counterproductive both in human terms and in financial terms and, of course, counterproductive to the performing arts in the United States.

We do believe that one abuse should be rectified. Tickets to popluar theatre and other performances, such as rock concerts, are frequently "scalped" at much higher than box office prices. I emphasize that the theatre receives only the box office price and the speculator's resale profit is likely to go untaxed. When used as business entertainment, taxpayers are likely to deduct the full price they pay. We believe it would be appropriate and useful to limit tax deductions in this respect to the box office price.

If you have any questions, I will be pleased to answer them.

The CHAIRMAN. Let me ask each of you, other than Mr. Hochberg because I have a different line of questioning for him: How did the theater or baseball or professional sports or clubs make it in this country, before there was an income tax from which you could take business deductions? Mr. Noll?

Mr. NOLL. Mr. Chairman, I can answer for clubs. Prior to that time, they were very elitist. It was the very wealthy, the highly privileged who formed clubs and were able to finance them. Since that time, the club industry has grown tremendously, and it has become more of a middle class industry. It really has. And I suspect, sir, that if we went back to a no-deduction thing, clubs would survive, but they would again become much more elitist than they are today. That small entrepreneur, that average professional might not any longer be able to afford it.

The CHAIRMAN. Mr. Susman.

Mr. SUSMAN. Mr. Chairman, the economics——

The CHAIRMAN. Let me ask you something further, if I might. As I understand the statistics, only six baseball clubs make money now, even with all these deductions. I assume before the income tax, more baseball clubs made money than make money now, and they made it with no deductions.

Mr. SUSMAN. I wasn't around when there was no income tax, but I can say that the economics of baseball have changed dramatically, as in Mr. Pollin's sports, mainly through collective bargaining and court agreements which have substantively changed the system. When there was no income tax, there was something called the reserve system. And we didn't have these high salaries. We lost that through court cases and then had to modify it through collective bargaining. So, the answer to the question is that it has changed dramatically. When Mr. Bush spearheaded the building of a stadium in St. Louis because the economics were good, he gave away the concession income to the entity that built the stadium in order to finance it. That can't exist today, and changes had to be made. I think that the bottom line is and the answer to your question is that the world has changed after there was income taxes. And in today's world, it would be absolutely disastrous—disastrous—to take away this deduction, when you consider the fact that of 81 percent of season ticket sales, 43 percent comes from business.

The CHAIRMAN. You tell me if this is the difference, and then I want to go on with Mr. Pollin. There were really two stages in the income tax. The first, after it was first enacted, when it was really just a marginal tax, and the second, beginning around World War II, when it became a significant revenue raiser, my hunch would be that in the 1930's the number of business tickets that you sold would be significantly less than now. This is my guess.

Mr. SUSMAN. That is true, and you have to understand, too, that communities have had to come forward and provide their support, as Mr. Pollin did here in Washington. I don't think that businesses were buying them in those days, but they weren't marketing like they were doing in those days. And employee benefits weren't as good in those days. And that is very important. The world has changed. We are proud of just the fact that somebody can go to a ballpark today and buy a $3.50 ticket and take a family of four and maybe spend $25 or $30, which is the lowest, cheapest, greatest form of entertainment in the world today, in our opinion, for that price.

The CHAIRMAN. Mr. Pollin.

Mr. POLLIN. I would have to agree very much with Mr. Susman's answer, sir. Basketball, hockey, football certainly were not, prior to the beginning of income tax, what they are today. Costs are way, way up. We have, as he said, collective bargaining. We have had court decisions which means that our costs are very, very much higher. There is no way that the sports can continue—as you suggested, that most of the baseball teams are losing money. Well, in hockey, I think 11 of the 14 teams are losing money; and in basketball, most of the NBA teams are losing money now. They are just starting to turn the corner. The NBA is starting to turn the corner, and some of the teams are becoming finally profitable. If this bill passes, it will be a disaster. I would also like to ask, if I may, or make a statement that football has joined in our views and has a statement they would like to put on the record, if I may, Mr. Chairman.

The CHAIRMAN. I will have it put in right after your statement.

Mr. POLLIN. Thank you.

The CHAIRMAN. Mr. Seidler, you have an even longer history than professional athletics in this country. The theater made it, survived without an income tax deduction. Why the difference now?

Mr. SEIDLER. We are the opposite. Prior to the income tax, theater was a dominant entertainment medium in the United States. Shuberts at one point had 229 theaters, if I remember the number correctly.

The CHAIRMAN. Legitimate theaters?

Mr. SEIDLER. Legitimate theaters. Along came something called talking pictures. Along came something called television, which drew off an enormous amount of talent, could afford to pay far more in talent, obtained advertising revenues. At the same time, the theater is making a handmade, hand-crafted product that can only be put on one show at a time—drama for about 800 seats in a theater, musicals up to about 1,600 seats. And when you have a hit, you can't stretch the walls of the theater. We are down now to 23 theaters. In our case, the answer is we had our prosperity prior to the income tax. It is not the income tax that changed it essentially. The change in the entire entertainment industry and media, and at this stage, we are in the opposite direction of the others. We are trying to hang on rather than build up.

The CHAIRMAN. Senator Chafee, I am asking the question that you have asked often as to how these industries made it prior to the income tax, because indeed we had baseball leagues and we had theaters and we had private clubs in this country. I have divided the income tax into two periods—the pre-1916 when there was no tax, but really pre-1940 because the major taxes in this country weren't imposed until World War II. Mr. Hockberg, let me ask you this, and this is an entirely different type of question because you bring a different perspective to us. What you are saying is that without those—and I would assume basically smaller businesses, whether they are in Corvallis, OR, or Eugene, OR, that purchase tickets to the Oregon State Beavers or the University of Oregon Ducks—that the revenue from football and basketball is what is supporting women's track and golf and tennis and swimming.

Mr. HOCHBERG. Absolutely, sir.

The CHAIRMAN. That is an aspect that is not often presented. We get examples of absolutely outrageous abuses of food entertaining or the salaries of Magic Johnson thrown in our faces, but very seldom think about the great bulk of athletics that produce next to no revenue. I assume that all of us would want to support these sports programs, and we would have to do it, I guess, out of State tax increases or local government tax increases unless we could continue to support these programs as we support them now.

Mr. HOCHBERG. Yes, sir. As I said in my statement, obviously one way of replacing lost dollars would be to seek local tax money, but I can only suggest again, as I did before, that one is robbing Peter to pay Paul. And I don't know that that is a particularly satisfactory way of resolving this problem. I think you have put the point in quite an accurate perspective.

The CHAIRMAN. You bring a different perspective, one that I think most of us hadn't thought about. Mr. Pollin, let me ask you, as an arena owner, not as a sports franchise owner: What is the effect of business deductions or business ticket purchases for ice shows, circuses, the other things that you would have in the Capital Centre?

Mr. POLLIN. We do have quite a bit of that. The percentages of tickets purchased for businesses for other than sporting events is not as high, but as an example, when I talked about the sky suites in the Capital Centre, without the sky suites we would not have been able to build the building. We took a survey recently of our sky suite lease holders, and we were shocked to learn that 90 percent—90 percent—of those people will cancel their leases at the Capital Centre if this bill is passed; 90 percent, which would be a complete disaster for the Capital Centre. And of course, they are all purchased by businesses, and they are not all big businesses. That is another fallacy that most people don't understand. They are small businesses. They are small real estate companies. They are small insurance companies. They are small companies that entertain clients, that have their employees come and watch events. Those people—90 percent of those people—have told us that they will cancel if this bill passes.

The CHAIRMAN. I would come back again to Mr. Hochberg. Most of the major public universities of this country are not located in the biggest towns in this country, and I would assume that the types of businesses that purchase tickets are local businesses. They have got to be plumbing contractors and electrical contractors and pharmacies. Most of those towns do not have big businesses.

Mr. HOCHBERG. That is very true, sir. If you take a look at the location of most of our State universities, they are not located in the major metropolitan areas, and the businesses that tend to support them would tend to be the smaller entities.

The CHAIRMAN. Senator Chafee.

Senator CHAFEE. Thank you, Mr. Chairman. Let me just ask you this. Everybody says that one of the objectives of the tax law is to achieve equity and simplicity is nice if we can also get that. You talk, Mr. Pollin, about the fact that the sky boxes are used by small corporations, perhaps with employees who go there. What is the equity in that? If I work for ABC Plumbing Corp. that owns a box and I go as an employee, and I go watch the Caps play; and I am another fellow who just works for a company and I go pay for my own ticket at your ticket office and buy it? Is there a fairness there?

Mr. POLLIN. I think that you weren't here, Senator, when I stated earlier that, when I determined to build the Capital Centre, I determined to build it without taxpayers' money—with private money. No Government money was involved, and I found that I was unable to build the Capital Centre with private money until I added the sky suites and added the revenue fees from the sky suites. Without that, instead of Abe Pollin and the mortgage company putting up $20 million, some Government agency would have had to put up the $20 million, and it would have been entirely taxpayers' money.

Senator CHAFEE. Whether that is true or not, I don't know.

Mr. POLLIN. I can assure you it is true.

Senator CHAFEE. That every sports facility is put up by Government money, but we get into a problem here. The previous panel, I take it, was the restaurant and hotel employees; and we get certain people who are getting their meals and seeing their sports events with, in effect, the Federal Government paying half of that. And the other people are going to the restaurant and paying for their own meals with after-tax dollars, going to see the Bullets play with after-tax dollars; and there seem to be some inequities involved here.

Mr. POLLIN. Senator, I have been involved in professional sports for 21 years, and I have listened and I am very close to the scene. And in all those years, I have never once, not once, ever heard somebody complain and say: "Hey, I am paying for this ticket with my own money, and the guy sitting next to me has got some sort of deduction," or even mentioned it to me or written me a letter about it. And I get thousands of letters from fans for all kinds of problems. Not once in the 21 years that I have been in professional sports have I heard that complaint.

Senator CHAFEE. And I will bet you get some choice complaints, too.

Mr. POLLIN. I certainly do. I also get some pretty nice praises, as well.

Senator CHAFEE. I am sure you do, and you deserve them. Fine.

Mr. SUSMAN. Senator, may I add a point on that on major league baseball because I had spoken very strongly on the fairness issue. And I echo what Mr. Pollin has said. And I would be willing to ask you all this very question: If you were to pick Washington, DC or Portland, OR or Honolulu or any city in the United States and a vote was taken, because I don't believe there is this human cry of the fairness issue on the deductibility of tickets, and they had the opportunity to vote here in Washington, what was more important to the average taxpayer—the person who is the blue-collar worker—whether they would rather have major league baseball here and have corporations support it by buying season tickets or have this deductibility, it is my belief that they would vote to have a major league franchise in their city which would create jobs, give them entertainment, create restaurants, hotels, motels, parking lots, vendors—everything you can think of—and not only that, but to improve the quality of life.

Senator CHAFEE. I am not going to dispute what you say because, going along with what Mr. Pollin said, I suspect that when sports facilities, arenas are put before the people on a bond issue or whatever it might be—I don't know what the percentage is—but I suspect in most of the cases, the people approve it, even though it is their tax dollars.

Mr. POLLIN. Senator, if I may add to that, as I suggested, I built the Capital Centre without Government or without any taxpayers' dollars; but most arenas and stadiums are built in this country with taxpayers' dollars and if this bill passes with the loss in revenue that these stadiums and arenas are going to have to bear, the cost of the bonds and meeting these bonds—the bond payments—that these cities have and these counties have is going to be a disaster. We have had people who wanted to come and testify with me that, if this bill passes as proposed, these cities and counties that have put up the money with bond issues would have a very difficult time meeting those bond payments.

Senator CHAFEE. I know my time is up, but I would like to ask one more question. Following that line of argument through, wouldn't it be a big step forward then if we made the price of tickets to sports events deductible for everybody? That would really help your business, wouldn't it?

Mr. POLLIN. I think it would help the business. I don't think that is in the cards, though. I think that a legitimate business expense should be deducted, if it is a legitimate business expense. If I am going to a theater, and I pay for my ticket to the theater, I am going for entertainment. That is fine; then I pay for it; but if somebody is paying my way and they are there to try to sell me something or I am an employee of that company and they are trying to have an employee benefit, that is a legitimate business expense, just like advertising, buying an ad on television, or any other legitimate business expense. It should be deductible.

Senator CHAFEE. I agree with the points you are making. I met with the restaurant owners, with the people at home, and they make the point of why we choose this area to not give the deductibility. If you rent a limousine to take your customer some place, you get the deductibility. What is the difference between taking them to the restaurant. Well, it is very difficult. Thank you very much, gentlemen.

The CHAIRMAN. Senator Matsunaga.

Senator MATSUNAGA. Thank you, Mr. Chairman, and I apologize for being late. There are so many places that a Senator has to be, and I apologize to the panel for not having heard their presentations, but I will be sure to read your written statements. I note, Mr. Pollin, that according to estimates that you have obtained, the Treasury will lose approximately $1 to $1.7 billion of tax revenue from the impact of the bill on the four major professional sports and their related industries. You called it the Shils report?

Mr. POLLIN. Yes. Dr. Edward Shils of the Wharton School of the University of Pennsylvania.

Senator **Matsunaga**. Was this done at the request of the sports industry?

Mr. **Pollin**. Yes. Dr. Shils was engaged by all of the sports to make this report. He sent out thousands and thousands of questionnaires to businesses, Fortune 500, smaller companies, numerous companies around the country. And if I may add to that, sir, he cut off the dates of this report so that it would be available for this morning, as of September 23; and at that time, he had 56.9 percent of all the people who answered who said that they would not renew their tickets. Since that time, and I talked to him yesterday morning, the responses have continued to come in; and that point is now up to 65 percent. Sixty-five percent have said that they would not renew their tickets if this bill passes as proposed.

Senator **Matsunaga**. What bothers me, as it must bother you, is that, here on the Hill, we tend to change our tax laws so often that you businessmen can't plan ahead. And as you point out, the proposed changes would affect a law which has been in effect for five decades. As I understand it, you financed that stadium, or the arena, which you built for hockey purposes. Is that right?

Mr. **Pollin**. That is correct. It was privately financed.

Senator **Matsunaga**. It was privately financed?

Mr. **Pollin**. Yes. No Government money and no taxpayers' money involved.

Senator **Matsunaga**. Right. And how much did you depend upon the law as it now stands to go ahead on your own initiative to build the arena with private funds?

Mr. **Pollin**. If the law was changed then as it is proposed now, the arena would not have been built. I would not have risked my own money, and I am sure the finance company also wouldn't have risked their money. There would be no Capital Centre today.

Senator **Matsunaga**. So, from your point of view, our changing the law now would be tantamount to our reneging on an implied agreement.

Mr. **Pollin**. That is correct, sir.

Senator **Matsunaga**. I tend to agree with you. Coming from a great sports town, Honolulu, I think I hear the same reasons for not changing as I hear from you this morning. And I thank you for confirming what my constituents have been telling me.

Mr. **Pollin**. Thank you, Senator.

The **Chairman**. Senator Symms.

Senator **Symms**. Thank you, Mr. Chairman; and gentlemen, I apologize that I was late and didn't hear your testimony, but this is a subject I am very interested in. The first question I have is directed at Mr. Seidler. What I would like to know is: What are the salaries of your Broadway actors? We always hear about the million dollar a year sports star, but what is the salary of a Broadway actor?

Mr. **Seidler**. If I recollect the last Equity contract correctly, a scale, which is what would be paid to the vast majority in any given performance, is $329 a week.

Senator **Symms**. Hardly a high salary, then?

Mr. **Seidler**. That is right, and that is when they work, and they work a relatively small proportion of the time. Leaving out the occasional star that performs in a Broadway play and if we paid them $1 million, that would be the gross for the year—leaving out that situation—the highest paid people in the theater are the stagehands who draw somewhere around $35,000 a year or that equivalent when they work in the theater.

Senator SYMMS. Thank you very much. I think that makes the point. In other words, whatever is lost in business is going to have an impact on the aspiring actor or actress who is not a high paid person at the present time?

Mr. SEIDLER. Exactly.

Senator SYMMS. What percent of revenue do you estimate would be lost? Maybe you have already answered that in your testimony.

Mr. SEIDLER. No, I haven't said it. Our feeling is there is a zero revenue impact, first of all, on the existing deduction because, as I did say in my testimony, legitimate theater is fully taxable so that, when a tax deduction is taken by a business to the extent that such is done, it is entirely reported as taxable income on the other side by the people who either work in the theater or own it.

Senator SYMMS. I mean the revenue loss will result in less profit from which to pay actors.

Mr. SEIDLER. Our guess is that we would lose somewhere in the range of about 5 percent. And as I said in my testimony, if we lost around 5 percent, our fixed costs are so high that we believe we would be facing closing the theater industry.

Senator SYMMS. Mr. Susman, I would like to ask you a question with respect to your season ticket sales. You are probably more familiar, of course, with the Cardinals than with other teams; but how many of the people who own season tickets really do use them as business expenses?

Mr. SUSMAN. We made a survey of all 26 clubs, Senator, and the season ticket sales—81 percent were bought by corporations—average.

Senator SYMMS. So, that is a substantial underwriting of stability within major league baseball. There is no question about that.

Mr. SUSMAN. It is the guts of it because the season tickets, without an adequate advance ticket sale, because you don't know what the team will do in performance, dictates a lot for attendance. So, it would be a disaster.

Senator SYMMS. Let me cite an example and you can tell me—any of you that want to comment—how many times you have found this to be the case. Last week, we had the United Fresh Fruit and Vegetable people in town. The group included a lot of onion, potato, and apple shippers from my State who work on the United board. One of those people came to talk to me about the Treasury proposal. He said, "Six percent of the U.S. population is in the Los Angeles area. It is on a good transportation route from Idaho, so Idahoans have a favorable freight rate into the Los Angeles area." This company owns four season tickets to the Los Angeles Raiders football games. Not one stockholder or member of the stockholder's family has ever attended a Los Angeles Raiders game, yet the tickets have been used every week by their customers. He said these complimentary tickets are the most positive thing he's ever done in terms of helping his company's reputation with the produce industry. He was outraged that the Treasury Department intends to deny him a deduction for this business expense. If he went down and bought advertising, that would clearly be a tax-deductible item; yet it would do them absolutely no good in the wholesale distribution center. He was upset about that contradiction.

Mr. SUSMAN. I wish he had testified for me. I agree totally.

Senator SYMMS. But I think that is often the case in these ideas. Thank you, Mr. Chairman.

The CHAIRMAN. Mr. Seidler, tell me something as a matter of curiosity. Every salary for the actors and actresses is roughly $330 a week?

Mr. SEIDLER. No. I said the Equity minimum scale, which is what the dancers, the singers, the vast majority of the performers receive, I believe, from the last contract was $329 a week.

The CHAIRMAN. About $17,000 a year, assuming they worked all year?

Mr. SEIDLER. Which they never do.

The CHAIRMAN. Which they never do. And the stagehands $35,000 a year, if they worked all year?

Mr. SEIDLER. That is right.

The CHAIRMAN. What does a stagehand do?

Mr. SEIDLER. The stagehands are the entire mechanism of the backstage performance. So, to the extent that you sit down in the theater and you see the scenery move or you hear the sound change, because those people are still part of the sound group, or the lighting change, local 1 covers almost all of those people. The stagehands are the guts of the mechanics of the production.

The CHAIRMAN. I am curious. Are those salary disparities based on comparable worth? [Laughter.]

Mr. SEIDLER. I think the salaries are based on the relative strength of the two unions. [Laughter.]

The CHAIRMAN. I have no other questions. Thank you. Any other questions? Senator Matsunaga?

Senator MATSUNAGA. As the father of two daughters in the performing arts, I wish they had become stagehands. [Laughter.]

Mr. SUSMAN. Senator, I think they ought to become baseball players.

Senator MATSUNAGA. When the subsidies for the performing arts were reduced by 50 percent by the incumbent President, not only his son was unemployed, but one of my daughters became unemployed. The older daughter, fortunately, was with a more solid firm and has been performing for 8 years now, going on 9. But I think those in the performing arts are sorely underpaid. I don't mean football players or basketball players or baseball players, but everything should be done to encourage the participation by those who have aspirations in the performing arts. I think it is a shame that we don't recognize the fact that, while everything else will fade into the past, the arts will be a reminder of the great civilization that we once put upon this Earth.

Mr. SEIDLER. Thank you, sir. I wish I could have put it as well.

The CHAIRMAN. Senator Chafee.

Senator CHAFEE. No questions, Mr. Chairman.

The CHAIRMAN. Gentlemen, thank you very much.

Now, if we might have Professor Blackburn, Mr. Calkins, Mr. Carter, and Mr. Nolan. I am going to wait just a moment until the room clears out and quiets down. Professor Blackburn, why don't you start?

STATEMENT OF JOSEPH W. BLACKBURN, PALMER PROFESSOR OF LAW, CUMBERLAND SCHOOL OF LAW, SAMFORD UNIVERSITY; OF SIROTE, PERMUTT, FRIEND, FRIEDMAN, HELD & APOLINSKY, P.C.

Professor **Blackburn**. Thank you, Senator Packwood. I am here today testifying in opposition to the President's proposal that would impose the accrual method of accounting on the entire service industry. And I first want to eliminate a misconception regarding the breadth of the applicability of this provision. There is a misconception that this rule will primarily hit attorneys and accountants. I am speaking today on behalf of several groups: The Fairness and Cash Method Group, which is a coalition of variety of Alabama businesses from the health care industry, plumbers, electricians, contractors, and others; I am also speaking on behalf of the Service Industries Coalition to Preserve the Cash Method, which consists of a broad group of very large health care providers, the broadcasting industry, the advertising industry; and again, others. I am also speaking on behalf of the Small Business Legislative Council, and the Small Business Council of America, which represents 4½ million small businesses from every range of the business community. This is not a provision with limited applicability. It is very broad in its scope. We all say with one voice that this provision is wrong. It is inappropriate. It is a revenue-producing provision, solely revenue producing. It is conceptually unsound. We believe that it is fundamentally unfair to ask taxpayers to pay taxes prior to their receipt of the money with which to pay the tax. Government literally is in partnership with business. Government shares in businesses' net profits, and it is unfair for one partner to insist that its share of profits come in advance in cash at the cost of the other partner which must wait until receivables come in and are actually collected. One of my constituents suggested that, if you would accept payment in accounts receivable, it might work; but you obviously accept payment in cash. They would like to wait to get the cash before they have to pay their taxes. The concept is fundamentally unsound. The cash-flow demands—I would refer to my written testimony, where in case study No. 1, I reflect a contractor who would be out of business absolutely, based on the cash flow demands under this proposal, due primarily to the transition rules that are also unfair within the proposal. The cash method is fair. It has been used by the vast majority of taxpayers since the inception of the tax system. It works. It is not subject to any significant abuse, and the revision is not proposed to reform any particular abuse. Abuse, if it exists at all, would lie in the accrual method of accounting. In the accrual method of accounting, there is more opportunity and more uncertainty as to those events that will trigger taxation. Persons impacted by this proposal can, for example, change their billing practices to try not to circumvent but properly change their billing practices to more clearly reflect the reality of the collectability of accounts. If something is not broken, and the cash method of accounting is not broken, we certainly ask Congress not to undertake to fix it. Not only is the broad concept unfair, the internal workings of this proposal are also extremely unsound. I refer initially to the conformity rule as it applies to small businesses. The conformity rule is nothing but a trap for the small businessman. This is the sort of proposal that ultimately leads to disrespect, and some would suggest, to later disregard or abuse possibly of the tax system. It is an unsound concept to penalize small businesses, perhaps for borrowing, for trying to use management reports for their own management decisions that might include accrual accounting. If they do that, they are now going to be subject to a tax penalty. The $5 million cliff, which is part of the internal working of the proposal, leads to discrimination and will lead really to antigrowth, I would say, within the service industry. Clinics, other companies will, in fact, break up to become smaller. All we really are asking is that Government be a fair partner and wait on its share of profits until they are collected. Thank you very much.

The CHAIRMAN. Thank you. Mr. Calkins.

[The prepared written statement of Mr. Blackburn follows:]

Testimony Before The
Senate Finance Committee
Of
Joseph W. Blackburn
Sirote, Permutt, Friend,
Friedman, Held & Apolinsky, P.C.
Of Counsel

Palmer Professor of Taxation
Samford University's Cumberland School of Law

Testimony presented on behalf of the Fairness In Cash Method Group in opposition to Chapters 8.03 and 8.04 of the President's Tax Proposals to the Congress for Fairness, Growth and Simplicity

October 4, 1985

ISSUE PAPER OF THE FAIRNESS IN CASH METHOD GROUP ON CHAPTER 8.03 OF THE PRESIDENT'S TAX PROPOSALS TO THE CONGRESS FOR FAIRNESS, GROWTH AND SIMPLICITY

I.

INTRODUCTION.

Chapter 8.03 of the President's Tax Proposal would require all businesses, whether individual proprietorships, partnerships or corporations, to convert from cash accounting to the more complex and costly accrual method of accounting if the business' gross receipts (regardless of actual income or loss) exceed Five Million Dollars, or if the business, no matter how small, regularly uses accrual accounting for any reports to owners, creditors or others. Chapter 8.04 of the Proposal simultaneously denies the reserve method of accounting for bad debts to all taxpayers. We strongly urge Congress to oppose Chapters 8.03 and 8.04 of the President's Tax Proposals. The adverse impact of these proposals may be summarized as follows:

1. Cash accounting reflects the more proper economic basis on which to report income for tax purposes. Fundamental fairness demands that taxpayers not be required to pay taxes on artificial income prior to collection of such income. Taxpayers must be able to collect their money *before* paying taxes.

2. If it's not broken, don't fix it. Treasury has not suggested that taxpayers, other than banks and

financial institutions, presently abuse or even have potential for significant abuse of the cash method of accounting. Thus, reform, except as it may apply to banks and financial institutions, is admittedly unnecessary.

3. The Proposal may require individual taxpayers, *e.g.* partners in a business, to borrow substantial amounts of money to pay current taxes on artificial income which has not and may never be received.

4. For contractors and other construction service businesses, e.g., plumbers, electricians, etc., the accrual method of accounting, by creation of current liabilities for tax purposes, directly reduces bonding capacity during periods of growth when bonding capacity should be expanding rather than shrinking.

5. For all affected industries, the proposal accelerates cash drains on businesses in order to pay taxes and the timing of such cash drains makes growth almost impossible. These cash drains arise under accrual accounting during periods of growth and expansion when cash is needed for most business development.

6. The provisions discriminate arbitrarily between service-oriented businesses, such as the medical industry, which cannot use the installment method of accounting for reporting sales, and businesses with inventories which do use the installment method of accounting for reporting sales.

7. The Five Million Dollars gross receipts standard arbitrarily places an onerous economic and competitive burden on one group of businesses within the affected industries, which does not apply to competitors within the same industries.

8. The Five Million Dollars gross receipts standard is arbitrary and discriminatory. In theory, the standard is excluding smaller businesses which cannot easily convert to accrual accounting due to its complexity. Due to the "Conformity Rule" this purpose is not in any way accomplished by setting the Five Million Dollar standard.

9. Conversion to and operation under the accrual method of accounting will be more costly and more complex for all affected businesses. Taxes cannot be reported on the accrual accounting method without all business records being maintained on a daily basis under this more complex, costly and time-consuming method of accounting.

10. Pursuant to the Conformity Rule many small businesses will be forced to adopt this more costly, complex method of accounting merely because their banks and credit agencies require their financial statements for loan applications to reflect accounts receivable and payable, *i.e.* accrual accounting. The Conformity Rule will apply to small businesses in a completely unfair, haphazard fashion.

11. Affected industries, including physicians and hospitals, will be forced to harden their credit and

collection policies resulting in increased screening and denial of services. Healthcare providers will have an increased transactional cost and reluctance to deal with assignment claims from Medicaid and Medicare.

12. For professionals, many accounts receivable must be included in income, but reciprocal deductions will be denied upon nonpayment due to custom and ethical considerations within the profession. For example, doctors and lawyers, on the basis of custom and ethical considerations, have difficulty pressing nonpaying patients and clients for payment, irrespective of their financial ability to pay.

13. The various rationale for the proposal as stated by the White House are fallacious. The only true rationale for the proposal is to produce a relatively small, one-time injection of revenue arising from the artificial acceleration and taxation of accounts receivable. This small, nonrecurring revenue will be achieved at the cost of tremendous, permanent complexity in tax and bookkeeping systems, and direct disincentives to economic growth within the affected service industries, heretofore the most rapidly expanding segment of our economy. Such unfair and arbitrary imposition of a tax is clearly discriminatory and ill-considered.

14. The principal source of revenue in the Proposal comes from the harsh six-year transition rule. Case

Study I discussed in the following testimony, reflects an estimated effective tax rate on the taxpayer of 83.79% during the phase-in period.

15. The only way to prevent subsequent abuse of accrual accounting if imposed within the service industry, is to force its application to work-in-process as well as to accounts receivable. If the "Taxable event" is submission of a bill or completion of services, the system will be impossible to administer. If extended to work-in-process on a percentage of completion basis, administrative and litigation burdens and costs will become a nightmare.

16. Neither the Kemp-Kasten nor Bradley-Gephardt proposals contain similar provisions.

This Issue Paper will first briefly state the current law and the stated rationale given in the President's Proposal for the proposed limitations. Finally, impact of the President's Proposal will be analyzed.

II.

ACCOUNTING METHODS - CURRENT LAW.

A. Presently Permissible Methods of Accounting.

The Internal Revenue Code presently permits a taxpayer to utilize the following permissible methods (or combinations of methods) of accounting for tax-reporting purposes:

1. cash receipts and disbursements method (cash method);
2. accrual method; or
3. any other special method permitted under Treasury regulations.

B. Cash Method v. Accrual Method.

Under the cash method of accounting, income will be reported when cash or a cash equivalent is actually or constructively received by a taxpayer. Expenses will be deducted when actually paid. By contrast, the accrual method of accounting provides for recognition of income when "all events" have occurred which establish the taxpayer's right to receive the income and the amount of such income can be determined with reasonable accuracy. Expenses, likewise, will be deducted only when "all events" have occurred which establish the fact of liability for payment, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred.

In general, taxpayers are permitted use of the cash method of accounting with respect to any trade or business. Taxpayers, however, who are required to use inventories because the production, purchase or sale of merchandise is an income producing factor in the taxpayer's trade or business, are required to use the accrual method of accounting, but only with respect to their purchases and sales of such inventory. Such taxpayers are also benefited by use of the installment method for reporting their sales. Most farmers are nevertheless allowed to utilize the cash method of accounting for their farming activities even though farming involves the production and sale of goods.

The Internal Revenue Service is presently authorized to change the method of accounting used by any taxpayer if such method does not "clearly reflect income" of the taxpayer's trade or business. In such a case, the Internal Revenue Service has broad discretion to require the taxpayer to use a method of accounting which does clearly reflect income. This broad, discretionary power presently allows the Internal Revenue Service presently to prevent any attempted abuse of accounting methods.

Chapter 8.03 of the President's Proposals would retain current limitations on the use of the cash method of accounting. For example, the "clear reflection of income" principal and required accrual accounting, modified by installment reporting, where inventories are present, would continue to apply. In addition to the foregoing restrictions on use of the cash method of accounting, the President's Proposals provide that no taxpayer would be permitted use of the cash method of accounting for a trade or business unless the taxpayer first satisfied both of the following conditions:

1. The trade or business has average (determined on a three-year moving average basis) annual gross receipts of Five Million Dollars or less (taking into account appropriate aggregation rules); and

2. The trade or business, other than a farming trade or business, has never regularly used any other method of accounting to ascertain its income, profit, or loss of the trade or business for the purpose of reports or statements to shareholders, partners, other proprietors, beneficiaries, for credit purposes or for billing of clients.

Taxpayers who are forced to report their accounts receivable as if they were income shall spread the adjustment over a period of six (6) years.

III.

STATED RATIONALE FOR THE PRESIDENT'S PROPOSALS.

In support of the proposed limitation on the use of the cash method of accounting, the President's Proposal expresses the following concerns with use of the cash method of accounting:

A. Failure to Reflect Economic Performance.

The President's report to Congress suggests that the cash method of accounting merely reflects actual cash receipts and disbursements and does not reflect the true economic results of the taxpayer's trade or business over a taxable year. The report notes that the cash method of accounting is not approved under Generally Accepted Accounting Principles.

B. Mismatching Between Payor and Payee Taxpayers.

The President's report further states that the cash method of accounting produces a mismatching of income and deductions as between payor taxpayers (purchasers of services) and payee taxpayers (providers of services), each of whom may employ different methods of accounting. The President's position is clarified in the following example:

> EXAMPLE: An accrual method taxpayer may deduct certain liabilities as incurred (even though not yet paid), such as liabilities for certain services rendered, even though the service provider on the cash method may defer reporting income until the amount due is billed and cash payment thereon is received. This would be typical of an accrual basis business accruing and deducting advertising expenses when incurred, though the advertising company

performing services would not report the associated income until payment is received.

C. Nondiscriminatory Treatment of Taxpayers.

Taxpayers in whose trade or business the production, purchase or sale of merchandise is an income producing factor, are presently required to use the accrual method of accounting with respect to their purchases and sales of inventory. The President's Proposal infers, and Treasury officials state, that one of the principal underlying purposes of the proposed cash method limitations is to prevent discrimination between service businesses and manufacturing and merchandising businesses.

D. Simplicity.

According to the President's Proposal, the principal support for the cash method is its simplicity, but simplicity is asserted to be a justifiable basis only for use of the cash method by smaller, less sophisticated taxpayers.

IV.

ANALYSIS OF PROPOSAL.

A. The Cash Method Properly Reflects "Economic" Performance.

The cash method of accounting may not conform to Generally Accepted Accounting Principles ("GAAP"), but neither does the accrual method of accounting as applied for tax reporting purposes. The cash method of accounting is, however, both simple and fair for tax accounting purposes and clearly reflects the economic results of operations of a trade or business for tax accounting purposes. Accounts receivable, at best, represent an expectation or hope of future revenues. Taxes should not be assessed and paid on the basis of hopes and expectations, but on the basis of collected, disposable income. Generally Accepted Accounting Principles have never been accepted by the Treasury or the Internal Revenue Service as the proper economic basis for tax accounting.

The accrual method of accounting, when applied in accordance with the artificial modifications imposed by Treasury Regulations and the Internal Revenue Service, *e.g.* the Claim of Right Doctrine requiring inclusion of receipts and income prior to their being earned, does not conform to Generally Accepted Accounting Principles. Neither does the accrual method more accurately reflect the "economic" results of operations of a trade or business than does the cash method.

Chapter 8.04 of the President's Proposals repeals the reserve method of accounting for bad debt deductions. Required accrual of all accounts receivable under Chapter 8.03 without regard to collectibility, and without utilization of the reserve method of accounting for bad debts, as would be required by Chapter 8.04 of the President's Proposals, absolutely violates Generally Accepted Accounting Principles.

Modification of the accrual method of accounting by repeal of the reserve method for bad debt deductions would create even greater distortion in accurate reporting of the "economic" results of operations under the accrual method of accounting as applied for tax-reporting purposes.

Clearly, the cash method of accounting potentially may produce a deferral of revenue for a short time period when contrasted with the accrual method. However, there has not been and there is little opportunity for abuse. When viewed in the foregoing context, the White House's assertion that the cash method should be eliminated because it fails to comply with GAAP is clearly disingenuous - a "red-herring" at best.

B. Mismatching Between Payor Taxpayer and Payee Taxpayer Would Likely Be Increased.

As a general rule,. if a higher percentage of taxpayers were all placed on the same method of accounting, whether cash or accrual, there would be some elimination of mismatching of income and deductions between payor taxpayers and payee taxpayers. There is nothing about the accrual method of accounting as contrasted with the cash method of accounting which would produce the result of less mismatching. Indeed, since more individuals are presently and shall continue to be cash method taxpayers, *placing professionals and other service organizations on the accrual method of accounting will likely result in greater mismatching of income and deductions rather than less.* In addition, many of an individual's payments for services *e.g.* repairs, healthcare, architect, *etc.*, are nondeductible, thereby rendering mismatching irrelevant for such payments. Again, the stated rationale of the White House is baseless.

C. Nondiscriminatory Treatment of Taxpayers.

Taxpayers who must maintain inventories are required to use the accrual method of accounting. The President's Proposals imply that equal treatment demands that noninventory taxpayers also be on the accrual method of accounting. This analysis fails to note the economic distinctions between service and nonservice organizations. The Proposals also fail to consider specific tax relief afforded persons who sell products which will not be available to service organizations.

Taxpayers who have inventories and are presently required to utilize accrual accounting are also allowed to utilize the installment method of accounting to defer reporting and paying taxes on future, uncollected income. The installment method of income reporting eliminates the cash-flow burden on such taxpayers arising from the accrual of accounts receivable prior to the receipt of cash or a cash equivalent. In many respects, *installment reporting allows accrual basis taxpayers to continue to report income and pay taxes on the cash method of accounting.* As stated in Chapter 8.02 of the President's Proposal, "[t]he installment method was intended to alleviate liquidity problems that might arise if a taxpayer was required to pay tax on a sale when he had not received all or a portion of the sales proceeds."

Use of the installment method is not available to taxpayers subject to the President's Proposal. Rather than alleviating discrimination, the President's Proposal creates discriminatory treatment.

In addition to the installment method of accounting, accrual method taxpayers have other special accounting devices available to them which are inapplicable to taxpayers impacted by Chapter 8.03. Use of the LIFO method in costing ending inventory leads to a gradual build-up over time of untaxed gain inherent in the difference between the fair market value of inventory and its reported cost. This "spread" is much like the untaxed spread between uncollected receivables and payables of a cash basis taxpayer. In addition, other special accounting rules such as the Completed Contracts Method of Accounting for long-term contracts are available to various industry groups presently on accrual accounting. Furthermore, manufacturers on the accrual method, due to the nature of their industry, have historically sheltered their income with investment tax credits, accelerated depreciation, heavy use of tax-free industrial development bond financing, etc.

By contrast, the service industry on the cash basis has few if any such special tax benefits. The service industry as a whole pays a very high effective tax rate since they are not capital intensive and receive very little benefit from investment credit, depreciation, etc. Under the cash basis of tax accounting, devices such as the Completed Contract Method of Accounting, Installment Sales, LIFO, etc. are inapplicable. Computation of taxable income is simple, straightforward and, unlike the accrual method, not subject to significant manipulation.

Service organizations, as contrasted with trades or businesses selling products and carrying inventory, will also bear a disproportionately large part of the burden created by the proposed repeal of the reserve method for bad debts when such repeal is coupled with the imposition of the accrual method of accounting. Due to local lien laws, statutory creditors' rights, and customary trade practices, including, importantly, the reluctance of professionals to pursue legal remedies in collection of accounts, merchants are much more likely to collect their accounts receivable than many service organizations, including particularly professional service organizations. Frequently professional service organizations choose not to collect debts which would not be deemed worthless or uncollectible and thereby not deductible under present Treasury Regulations. Thus, a physician who submitted a bill to a patient would be required to include the account receivable in taxable income and pay tax thereon. When the patient refused or failed to pay, the physician, in order to receive a bad debt deduction in the subsequent year, would be required to sue or produce evidence, if available, of the patient's inability to pay. If the physician failed to sue a patient who was able to pay, no deduction would be granted.

D. Exclusion of Small Entities While Taxing Individuals Associated With Larger Entities In The Name of Simplicity Is Arbitrary And Capricious.

The President's Proposal would ostensibly retain the cash method of accounting for most individuals, since it is only applicable to "a trade or business" and would also only apply to large trades or businesses, *i.e.*, except for the conformity requirements, it would not apply to trades or businesses with average annual gross receipts of Five Million Dollars or less.

Although the change is applicable only to trades or businesses, it will effectively impose accrual accounting on individual owners of such trades or businesses, including individual partners in service organizations. Such individuals, as well as all other businesses subject to the rules, will have severe cash flow problems because they will be required to pay tax with respect to the income derived from the partnership or proprietorship on accrued but uncollected income. This Proposal represents a severe form of arbitrary, economic discrimination between individual professional taxpayers who are similarly situated in all respects except for the amounts of the gross receipts of the firms to which they happen to belong.

The purpose of the Five Million Dollars standard is to segregate and exempt "unsophisticated" taxpayers who should not be burdened by the added complexity of the Proposal. *There is little or no nexus between a taxpayer's ability to report taxes on the accrual method of accounting and the level of gross receipts of a business.* This standard would label as "unsophisticated":

1. All certified public accountants who do not practice with the larger firms;
2. Other well-educated professionals and businessmen;
3. Innumerable taxpayers who are just as capable of paying for accounting information as persons whose firm's gross receipts exceed Five Million Dollars;
4. The vast majority of persons who are capable of and who are presently retaining professionals to plan and prepare their tax returns;

5. Persons who presently prepare their taxes and deal with provisions of the Internal Revenue Code just as, if not more, complex than requirements of accrual accounting.

As reflected in the Case Study II (V., below), the Five Million Dollars standard creates substantial disincentives for service organizations to grow larger. Service organizations subjected to the rule will have greater difficulty recruiting qualified personnel and competing in every respect with slightly smaller, similarly situated organizations not burdened by the additional tax. Larger organizations founded to benefit from economies of scale and to provide improved service to the public would have substantial incentives to break-apart into smaller, less-efficient units.

E. Impact On Small Businesses Under The Conformity Rule Is Unfair and Haphazard.

Impact of the Conformity Rule on samll businesses is one of the most unfair, yet least recognized provisions of the Proposal. Different types of financial information are prepared for and utilized in many different ways by businesses and their owners, managers and creditors. For purposes of projections and cash flow planning a small business should and must use accrual accounting. Various financial ratios, e.g. current ratio, acid-test ratio and debt to equity ratio, are premised on accrual accounting information and are important projection tools for both management and creditors.

The Proposal's Conformity Rule represents a severe tax penalty imposed haphazardly and capriciously on those small businesses who undertake to grow through debt-financing of growth or who try to apply sound management techniques through development and use of the full available range of accounting information.

Thus, the small business which is informed of this severe tax penalty must terminate its borrowing from creditors who ask for accrual basis financial information and must discontinue development and management use of accrual basis financial information. The small business which is unaware of this obscure yet severe tax penalty will merely fall into this newly created "tax trap".

The President's Proposal suggests that only a small percentage of businesses will be impacted by the Proposal. This estimate is based on the Five Million Dollar standard and ignores the tremendous impact of the Conformity Rule. Indeed, due to the large number of small businesses which borrow or which use some accrual accounting information for management, the Conformity Rule may indiscriminately trap a larger number of taxpayers than the Five Million Dollar standard.

V. CASE STUDIES

Case Study I

The Company, which is the subject of this Case Study, is located in the State of Alabama and began business in 1962 as a small, family-owned venture. Total initial capital was $400. The Company was incorporated in 1970 but has remained a family-owned business. Presently, the Company has almost 3,500 union employees on its payroll. The Company's annual payroll is approximately $16,800,000, plus over $5,600,000 paid through subcontractors. Activities and payroll of the Company presently cover the six states of Georgia, Alabama, Mississippi, Florida, Tennessee and West Virginia. The Company's business is provision of contracting services to industrial plants for installation of major industrial machinery and equipment which the Company's customers have purchased from other suppliers. The Company does not sell products or machinery to its customers, but solely provides engineering and contracting services and is, therefore, a labor-intensive business. The Company is properly a user of the cash method of accounting and has used the cash method of accounting since its inception.

Accountants recently made financial projections to determine the impact of Chapter 8.03 on the Company's operations. These calculations included application of the Proposal to the preceding six year operations of the Company as well as projections for the six year period beginning for

1986. The completely disastrous impact of the Proposal as reflected in such calculations may be summarized as follows:

1. Large amounts of working capital absolutely essential to meet large weekly payrolls and other current cash demands are, under the Proposal, pulled out of the business at precisely the time they are most needed to provide for economic growth.
   - (a) A period of business growth began for the Company in 1981 and carried through 1982. Thus, working capital was greatly needed during this period in order to finance growth.
   - (b) A business downturn for the Company occurred in 1983 thereby reducing the need during 1983 for business working capital.
   - (c) Under the cash method, large tax obligations arose and were properly payable in 1983 as accounts receivable were collected and cash became available. The cash method of accounting properly matched tax obligations with availability of cash flow to make payments.
   - (d) Under the accrual method, tremendous tax obligations would have arisen and been payable

in the 1981-82 growth period. Thus, at precisely the time (1) more cash is needed for working capital to meet economic growth, and (2) the least cash is available, the Proposal would place an impossible cash demand on the Company.

2. The Company would not have survived, much less been able to grow, if the timing of cash demands placed on the Company by the accrual method had in fact occurred during 1981-82.

    (a) Total combined Net (Cash Basis) Income of the Company for 1981 and 1982 was $770,474.84. Total combined tax liability payable for 1981 and 1982 under the accrual method would have been $1,684,854.25.

    (b) Even if the entire 1981-82 cash Net Income of $770,474.84 was applied to pay taxes, the Company still, under the accrual method, would have been confronted with the impossible task of paying in cash an additional $914,379.41 in taxes.

    (c) This cash shortfall of nearly One Million Dollars, even after having paid out the Company's entire cash Net Income, obviously makes growth impossible and survival of the Company doubtful if taxes were determined under the accrual method.

3. For the six years following its adoption, the Proposal would place a clearly, unacceptably high tax burden and cash demand on the Company.

   (a) Based on reasonable projected income fluctuations derived from the Company's prior operating history, the aggregate tax rate imposed on the Company by the Proposal for the six-year phase-in period is 83.79%. See Exhibit "A", attached.

   (b) Based on actual income for the six years ended September 30, 1985, the aggregate tax rate which would have been imposed on the Company if the Proposal had been enacted at the beginning of such six-year period is 59%.

4. Based on present receivables and work-in-process spread of $6,660,000.00, the Proposal would require payment of taxes totalling $2,220,000.00 ($370,000.00 annually) over the subsequent six-year phase-in period attributable to the one-time artificial creation of income arising solely from conversion from cash accounting to accrual accounting. This tax would be payable even if the Company had losses during the six-year period.

5. Irrespective of cash-flow and tax burdens, the Company cannot maintain its present size and

clearly is prevented from growing due to the Proposal's impairment of the Company's bonding capacity. The increased tax liability, whether attributable to accrual accounting or the artificial conversion income, constitutes a current, balance sheet liability and reduces bonding capacity $10 for every $1 of such added current tax liability.

(a) Considering only the annual $370,000.00 tax liability from artificial conversion income, the Company would lose bonding capacity of $3,700,000.00 given the 10/1 bonding ratio. Since the Company uses, i.e. turns-over, its bonding capacity approximately 4.5 times annually, the Company's bonding capacity and corresponding ability to work would be decreased $16,650,000.00 annually.

(b) Just as discussed for cash flow in paragraph 1. above, reduction in bonding capacity attributable to increased tax liability is triggered by attempted growth. At the precise time of business expansion, bonding capacity would be automatically reduced by the burgeoning current tax liability.

6. Management of the Company has, after careful consideration, already reached the management

decision that the Company must literally liquidate itself out of existence during the six-year phase-in period if the Proposal is enacted.

As evidenced by the preceding, the antigrowth impact of Chapter 8.03 surely has not been well and fully considered. The fundamental lack of fairness and adverse impact on the entire service industry, including especially the adverse impact on any cash basis taxpayer who is attempting to grow, requires that this proposition be excluded from proposed tax reform legislation.

CASE STUDY II

A healthcare clinic located in Birmingham, Alabama, was formed by groups of physicians in order to provide improved medical service to their patients and to utilize economies of scale. The clinic practice presently includes ninety physicians representing over twenty specialties and subspecialties. The most advanced diagnostic and laboratory equipment is available on site, and professional management has been retained for proper and efficient operation. The clinic's operation over time has ultimately provided the anticipated benefits of efficient delivery of superior healthcare services.

Quality of healthcare service to patients has been markedly enhanced. The wide range of available specialties gives the best available medical care on a consistent continuous basis at one location. Thus, a patient's entire healthcare is centralized and properly coordinated. Convenience to patients is maximized by having one set of medical records, one location for physician care and laboratory services, and one coordinated billing and insurance filing procedure. Physicians are relieved of inefficient and distracting administrative matters and can devote their full time and attention to patient care. Healthcare costs are reduced as a result of this more economically efficient structure.

Substantial economies and reduced costs have been realized from this clinic structure for medical practice. All personnel, purchasing, billing and other administrative matters are centralized. X-ray, laboratory and other diagnostic equipment is centralized and efficiently maintained and operated, thereby avoiding the duplicity of investment and operational costs which are associated with smaller, nonclinic medical practices.

As a clinic, the aggregate gross receipts of the physicians exceed Five Million Dollars. The clinic will be subject to Chapters 8.03 and 8.04 with the following results:

1. The vast majority of the individual specialty groups can avoid application of the added costs and complexities by disbanding the clinic. By practicing as independent specialty groups, the added tax burden can be

avoided. The benefits of the clinic structure to patients and to the economy through reduced healthcare costs will be lost.

2. If the clinic were to continue to operate, substantial, continuing administrative costs would be incurred. Cost of implementing entirely new bookeeping systems and procedures would have to be incurred. Complexity of operating under the new accounting system and of increased screening of accounts receivable would require at least three (3) new, full-time employees.

3. Physicians who routinely and unselfishly presently provide indigent healthcare will now receive a significant financial tax fine for all such work. Indigent patients are now routinely treated as any other patients. Accounts receivable are created but later identified and written-off. Physicians would be required under the Proposal to pay an advance tax on all such uncollectible accounts which are routinely part of accounts receivable at year-end. The only way to avoid the tax penalty would be a complex, costly and time-consuming system of prescreening and segregating the indigent patient -- an improper and undesirable practice.

4. Physicians are increasingly being forced to reduce their charges for Medicaid and Medicare patients. Presently, profitability for many individual physicians is marginal on Medicaid and Medicare assignments. The new tax

burden further increases the cost of and thereby reluctance to handle Medicaid and Medicare assignments.

5. Physicians who continue to deal with Medicaid and Medicare will demand accelerated payments on accounts or advance deposits to offset the cash-flow hardships created by the advance tax payments required.

6. Under present Treasury Regulations, uncollected accounts, contrary to present practice, must routinely be turned over to collection agencies or suit filed merely to establish necessary evidence of their uncollectability to support a bad debt deduction.

7. Pro-competition advocates for the healthcare industry will receive a major setback. Private healthcare providers are presently the most innovative, highly competitive, cost-efficient, and fastest growing segment of the healthcare market. This Proposal drains tremendous amounts of cash-flow, thereby inhibiting growth and places an ever-increasing tax handicap on their ability to compete with other, nonprivate segments of the industry.

VI.

SUMMARY AS TO FAIRNESS, GROWTH AND SIMPLICITY.

A. Fairness.

Fundamental fairness requires that *the government not collect its taxes before taxpayers have collected money with which to pay their tax.*

Availability of installment sales reporting to manufacturers and merchants allows (1) deferral of taxes on income from sales not actually or constructively received, and (2) current deductions for all operating, general and administrative expenses despite deferral of installment sales. There is no present unfairness or discrimination against such taxpayers employing this accounting methodology when compared to the cash method. Unfairness and discrimination would arise under *the President's Proposal through imposition of only the burdensome part of the foregoing accounting methodology, i.e.* accrual accounting, without relief of the important, ameliorating installment sales rules.

Discrimination against larger, more efficient service organizations is arbitrary and reflects regressive economic policy.

Haphazard application to small businesses under the Conformity Rule is utterly unfair and clearly shows the lack of careful analysis which has been given by Treasury to this hastily contrived, ill-considered proposal.

B. Growth.

The President's Proposal creates a significant economic disincentive to form or to retain larger service organizations. The service industry will be the principal source of growth for the American economy in domestic and foreign markets. Tax laws should not create disincentives to growth.

The President's Proposal will also artificially create major increases in immediate cash requirements for service organizations and for their customers and clients. This large, new cash demand will place further, unnecessary pressure on interest rates thereby inhibiting economic growth.

C. Simplicity.

The President's Proposal recognizes that the goal of simplicity will be best served by retention of the cash method of accounting. *Enormous complexity with accompanying costs to taxpayers and to the Treasury will result from the widespread conversion to the accrual method of accounting.*

VII.

RECOMMENDATIONS.

1. Delete the proposal. Neither the Bradley/Gephardt bill nor the Kemp/Kasten bill proposes such broad-based imposition of the accrual method of accounting.

2. If banks and other financial institutions are determined to be abusing the cash method of accounting, then the Proposal should be limited to such entities.

3. If the President's Proposals are enacted, fairness dictates:

a. establishment of an installment method type of deferral of income recognition, accompanied by corresponding deferral of appropriate deductions, though not all operating costs should be deferred.

b. retention of the reserve method for bad debts.

c. clarification to assure that income attributable to "work-in-process" or contingent fee arrangements would not be deemed to be recognized until actually billed at the completion of the performance of services. This position represents the best of two unfortunate options.

d. elimination of the phase-in adjustment, or creation of a suspense account for existing accounts receivable *in lieu* of the six-year phase-in.

CONCLUSION.

The stated rationale of the President's Proposals as to the cash method of accounting do not withstand scrutiny. The President's Proposals on this issue promote discrimination, complexity and disincentives for capital formation among service organizations. Clearly there would be arbitrary discrimination among service organizations and between the service industry on one hand and the manufacturing and merchandising industries on the other hand if the Proposal were enacted. The proposed change is an ill-considered, revenue producing measure which is arbitrary and discriminatory in its application. The cash method of accounting is economically sound, fair and should be retained. *Taxpayers should not be required to pay taxes on money they have never received.*

STATEMENT OF HUGH CALKINS, CHAIRMAN, AMERICAN BAR ASSOCIATION, SECTION OF TAXATION, CLEVELAND, OH

Mr. CALKINS. Thank you, Senator Packwood. I am Hugh Calkins. I am chairman of the tax section of the American Bar Association. I appear here today at the request of its president, William W. Falsgraff. The American Bar Association is on record as supporting fundamental tax reform in this country. We want the tax system to move in the direction of a broader tax base, of greater simplicity, and of greater stability. Many of our members have submitted individual comments with respect to the President's proposals for fundamental tax reform, and a good many of those comments suggest that the base should be broadened further than the President has suggested. Nevertheless, I appear here today on behalf of the American Bar Association to oppose the proposal included in the President's package, to require that personal service organizations with gross receipts of more than $5 million compute their taxes on the accrual rather than on the cash method; and I do so because that proposal will be seriously damaging to many of the 300,000 members of the American Bar Association. And in our view, it does not have any sound foundation in economics or in practice or in good tax policy. There are five reasons why the American Bar Association opposes this particular proposal, and there are five reasons why we believe that members of the Senate Finance Committee who are generally in sympathy with the objectives of the President's proposal, to broaden the tax base and reduce the number of deductions, can, consistently with that general point of view oppose this particular proposal.

The first is that the law firms which use the cash method do so for internal purposes as well as for tax purposes. They determine annual distributions to partners, they determine what will happen when a new partner joins the firm. They determine what happens when a partner retires—on the cash method and not on the accrual method.

Second, no material game playing with that process has been identified. The deferral of income which results from using the cash method is generally 30 to 90 days, rarely more than 180 days. Billing and collection are conducted by law firms with no regard to the taxable year of their client and with virtually no regard to whether their client gets a deduction for the amount which is paid for the legal services.

Third, personal relationships between lawyers and clients, which to lawyers are very important, preclude factoring of receivables, a practice which is very common among commercial organizations of about the same size as the law firms which will be affected by this proposal.

Fourth, the cash method has very important business advantages to law firms. It imposes a healthy discipline for sending out bills and collecting receivables on busy people who, without the discipline, would find it much easier to attend to legal problems and not pay much attention to the business aspects of their practices. These advantages are so great that I think it is almost certain that most of the law firms which are adversely affected by this proposal would, if it were to be enacted, continue to use the cash method for determining their annual distributions to partners. For these reasons, the President's proposal is viewed by lawyers—and we suggest should be viewed by this committee—as a means to achieve tax neutrality in the overall reform package by imposing an additional tax burden warranted only by revenue considerations on one group of taxpayers.

Fifth, and finally, the burden of the proposal is roughly and on average equivalent to requiring these taxpayers to make an interest-free loan to their Government equal to the income tax that would be imposed on between one-third and two-thirds of their annual income. Now, it may not be self-evident how that figure reconciles to the 30- to 90-day receivable figure which I gave you, so let me explain. In the typical law firm, the share which is distributed to the percentage partners who will bear the burden of this proposal is rarely more than one-half and frequently only one-quarter of the gross receipts. And if you take the 60-day average of receivables and multiply it by two or by four, you get to my one-third and my two-thirds figures. If the Treasury should follow through on its suggestion that it will try to impose this theory on unbilled services performed, and if that should be sustained by the courts, then the burden will be twice as great as the burden that I have described.

The CHAIRMAN. Thank you. Mr. Carter.

[The prepared written statement of Mr. Calkins follows:]

STATEMENT OF

HUGH CALKINS, CHAIRMAN

SECTION OF TAXATION

of the

AMERICAN BAR ASSOCIATION

before the

COMMITTEE ON FINANCE
UNITED STATES SENATE

with respect to

Proposed Requirements that Personal Service Business Organizations Adopt Accrual Basis of Accounting

October 4, 1985

AMERICAN BAR ASSOCIATION

SECTION OF TAXATION

REPORT TO THE HOUSE OF DELEGATES

RECOMMENDATION

RESOLVED that the American Bar Association recommends that Congress reject the Administration's proposal to require many personal service businesses, which now compute taxable income on the cash basis, to convert to the accrual basis.

FURTHER RESOLVED that the Section of Taxation is authorized to urge the foregoing position on the proper committees of the Congress.

REPORT

The Administration's tax reform proposals of May 29, 1985, would require all taxpayers who meet either one of the two conditions to compute taxable income in accordance with the accrual method. This would be required if either (1) the business has gross receipts (computed on the basis of a three-year moving average) of $5 million or more, or (2) the business (other than a farming business) uses the accrual method in preparing reports to owners, creditors or others. Under this proposal, any business having gross receipts of $5 million or more would thus be denied the use of the cash method. Moreover, every such business would be required to pay a one-time tax, spread over a six-year period, on the balance of its accounts receivable less its accounts payable on the effective date of the change in method.

As applied to personal service businesses, this proposal is unsound for the reasons discussed below. This discussion and accompanying resolutions are limited in scope to the application of the Administration's proposal to businesses that provide personal services. The Association is not sufficiently familiar with the particular issues presented by businesses that provide other forms of service either to support or to oppose application of the proposal to them.

1. The Cash Method Clearly Reflects Income

The cash method is simple in application and fair in result. If income is properly represented by spendable assets, the cash method clearly reflects that income because it treats the receipt of cash (or a cash equivalent) as the event producing the income. While accounts receivable may represent an accretion to wealth, they do not represent disposable income until collected, factored or otherwise converted to cash.

Accounts receivable and accounts payable clearly are important to a determination of the financial condition of a business or to an assessment of its future prospects. They are not, however, critical to a determination of its current spendable income.

The conclusion that the cash basis clearly reflects income is substantiated by the fact that the owners of personal service businesses generally deal with one another on the cash basis. Thus, major events such as the admission of new members, the periodic revision of income interests, and the withdrawal of existing members are generally accounted for on the basis of the cash method. For example, newly admitted members generally share in cash collections following their admission even though the collections may result from work done or billings sent prior to admission. Similarly, periodic changes in income interests often apply to all subsequent cash collections. Withdrawal of members seldom results in a continuing interest of the withdrawing member in outstanding receivables. The fact that owners of personal service businesses are willing to deal with one another in these situations in accordance with the cash method attests to their belief that the cash method clearly reflects the income of the business.

There is no evidence to indicate that a significant number of cash basis businesses manage their affairs so as to defer artificially the receipt of taxable income, for example, by originating billings late in a taxable year to cause the resulting income to be taxable in the following year. Most cash basis businesses, particularly the larger ones that would be impacted by the proposal, have aggressive billing and collection practices that tend to accelerate rather than defer the receipt of income. Indeed, if manipulation issues are of concern, the proposal is ill-founded because it is far easier to manipulate the timing of a billing under the accrual method than it is to manipulate the timing of a receipt under the cash method.

If, to avoid manipulation, the proposal were to require accrual of work in process, major accounting and valuation problems would result. Sellers of professional services do not ordinarily maintain price lists for particular kinds of client services and the amount ultimately billed and collected often results from a process of negotiation. Thus, the amount actually paid by a purchaser of services may differ drastically from the putative value at which carried on the service provider's books, or even from the amount billed for those services. For these reasons, the cash method is ideally suited to measure the income of service providers and that method does not appear to be the subject of significant abuse.

Taxable income of a business that is neither growing nor shrinking significantly in size will be the same for any given period whether measured under the accrual or the cash method. Accordingly, the proposed change would not, in the long run, have any significant tax revenue effect beyond the imposition of a one-time tax that would be occasioned by the change itself. As is true of most changes in accounting method, the longer-term effects are considerably less significant than is the distortion that results from the change itself. This one-time tax would not be the product of any increase in income, net worth or ability to pay of the affected business enterprises; rather, it would be solely the product of the required change in accounting method.

2. The Problem of Mismatching

The Administration refers with concern to the fact that accrual basis purchasers of services may deduct those costs when incurred and yet cash basis providers of services do not recognize income until cash is received. In personal service situations this is a very short-term problem, and such mismatching as does occur is normally resolved within the scope of a twelve-month period and seems to be of trivial consequence to the tax system and the economy. Accordingly, those situations do not involve the kinds of concerns that are presented when accrual deductions precede by many years the economic performance that results in offsetting income.

Indeed, when Congress has addressed issues of mismatching, it has exempted short-term situations. For example, sections 467 and 1272-1275 generally exempt events occurring within the period of one year. Alternatively, Congress has fashioned special matching rules to meet particular situations without imposing wholesale method changes; for example, see sections 267 and 404(d) where concurrence of the timing of particular inclusions and deductions is mandated. In short, if short-term mismatching in this area is a problem, there are better solutions.

Beyond this, the Administration's proposal would result in a significant level of "reverse" mismatching where cash basis service purchasers deal with accrual basis service providers. Many clients of service providers are cash basis individuals; others are required to capitalize and defer deduction of service fees. Thus the Administration proposal would necessarily accelerate the inclusion by service providers even where deductions are available to clients only in subsequent periods.

3. The Proposal Is Inherently Inequitable and Economically Inefficient

Sellers of services are not entitled to report income on the installment plan, and yet this method is electively available to sellers of products, a feature that effectively places the latter group on a modified cash method. The Administration proposal thus discriminates against sellers of services. The installment plan exists because the receipt of a spendable asset, i.e., cash, is the primary indicator of income for tax purposes. The availability of that plan to product sellers is an important and realistic feature of the tax law. To withdraw from sellers of services the similar important and realistic features of the cash method would be highly discriminatory. If the proposal were modified to allow installment reporting by personal service businesses, the result would be a modest change in tax revenues and a substantial increase in complexity.

The Administration proposes at the same time to deny to accrual basis taxpayers the right to maintain a bad debt reserve. A bad debt reserve is a realistic recognition that not all accounts receivable will ultimately collected. Denying the right to maintain such a reserve assures that tax will be paid on income that will never be received, thus compounding the unfair effect of denial of the cash method to service providers. This represents in a very real sense a taxpayer loan to the Treasury of money that will not ultimately be owed as taxes. This is surely a distortion that should not be permitted to exist.

The artificial dividing line of $5 million in gross receipts between businesses that would and would not be subject to the proposal introduces complexity and promises to have other undesirable effects. It assures that those businesses that grow or that combine to produce receipts in excess of the threshold will be disadvantaged vis-a-vis those that do not. It assures that decisions as to size, whether by way of growth or by way of combination, will be heavily influenced, if not controlled, by the attendant tax consequences and should not be constrained by artificial but compelling tax consequences.

James B. Lewis
Chairman

STATEMENT OF BILLY R. CARTER, CHAIRMAN, TAX AND FISCAL AFFAIRS COMMITTEE, THE ASSOCIATED GENERAL CONTRACTORS OF AMERICA, EL PASO, TX, ON BEHALF OF THE NATIONAL CONSTRUCTION INDUSTRY COUNCIL

Mr. **Carter**. Thank you, Mr. Chairman. My name is Billy R. Carter. I am chairman of the tax and fiscal affairs committee of the Associated General Contractors of America. I am here today representing the National Construction Industry Council, which is an organization made up of the 25 major trade associations and professional societies representing the construction industry. The membership of these organizations consists of more than 200,000 construction and construction-related companies employing more than 4 million employees.

We appreciate the opportunity to comment on the topic of comprehensive tax reform. My testimony will concentrate on the proposed changes that will affect the use of the completed contract method of accounting in the construction industry. At the outset, let me be emphatic that the construction industry is not the source of the perceived problems with the use of the completed contract method of accounting. Completed contract accounting was widely recognized as the appropriate financial accounting method for the construction industry even before the enactment of the income tax law in 1916 because of the unique nature of the construction industry. Let me be equally emphatic that elimination or significant revision of the completed contract method of accounting for the constructon industry will quickly bankrupt thousands of construction firms and will have a devastating impact on the work force in our industry. The ripple effect from this disruption will resound throughout the entire economy. I should also point out that the 3- to 5-year horizon used in the tax revenue projections from these changes will not raise any additional revenue from the construction industry. We are already paying these taxes on our profits when the projects are complete and in that timeframe. My written statement, which I submit for the record, also shares with you the industry's concerns regarding other provisions of the proposed comprehensive tax reform. The $343 billion construction industry's impact on the entire economy is so vast that the industry feels a strong sense of responsibility to bring to your attention not only the adverse effect of the proposed changes in the completed contract method of accounting, but also alert you to other proposed changes which will add to the adverse impact. The administration, Senator Bradley, Representative Gephardt, Representative Stark, and Senator Roth have recommended four different proposals affecting the use of the completed contract method of accounting. Each of these proposals and others were reviewed and rejected by Congress in 1982 during its consideration of the Tax Equity and Fiscal Responsibility Act. The construction industry is unified in its opposition to all of these proposed changes. All of these proposals share an apparent common interest in eliminating perceived abuses in the use of the completed contract method by some industries. The construction industry, however, is not one of these abusing industries. We are not latecomers to the use of the completed contract accounting, nor are we an industry with 10 to 20 years contracts, which postpone reporting income for tax purposes for extended periods. We are instead the very industry for which this accounting method was first included in Treasury Department regulations in 1918 because of the unique nature and inherent risk of our industry, a risk not found in other industry users of the method. Congress confirmed this in 1982 during the last round of legislation on the completed contract method of accounting. At that time, Congress implemented cost allocation rules for users of the completed contract method but directed that none of the new rules be applied to construction contracts lasting less than 36 months or to any construction contractor with less than $25 million in annual gross receipts. In doing so, Congress specifically recognized the differences between the industry users of the method. Of the hundreds of thousands of construction companies, less than 1 percent will have revenues in excess of $25 million. Very few construction contracts extend more than 3 years. This means that taxes are paid on virtually all construction contracts when the project that is being constructed is completed and in less than 3 years. The administration's recognition of the importance of the traditional use of the completed contract method of accounting in the construction industry went even further than the action taken by Congress in 1982. Following the Tax Committee's markup of the 1982 Tax Equity and Fiscal Responsibility Act, then-Secretary of the Treasury Donald T. Regan wrote the Senate Finance Committee Chairman Robert J. Dole that "after further consideration, I am concerned that the Senate provision dealing with the completed contract method of accounting is perceived to have an unnecessary adverse impact on the construction industry at this time." If Secretary Regan's recommendations had been acted on, there would have been no change at all in the construction industry's use of the completed contract method of accounting. I have included a copy of Mr. Regan's letter with my written statement. The vast majority of——

The CHAIRMAN. I will have to ask you to conclude, Mr. Carter.

Mr. CARTER. Very good, sir. The vast majority of construction companies operate in a high-risk, low-return environment. They are greatly undercapitalized and maintaining a survival rate of cash flow is an every day fact of life. To eliminate or significantly revise the completed contract method, as threatened by these proposals, would cause further severe cash shortages in an industry already beset with a lack of adequate cash reserves. I would be pleased to answer any questions.

The CHAIRMAN. Thank you, sir. Mr. Nolan.

[The prepared written statement of Mr. Carter follows:]

TESTIMONY

OF

BILLY R. CARTER

PRESENTED TO

THE FINANCE COMMITTEE

U.S. SENATE

ON THE TOPIC

OF

COMPREHENSIVE TAX REFORM

ON

OCTOBER 4, 1985

NATIONAL CONSTRUCTION
INDUSTRY COUNCIL

Thank you. My name is Billy R. Carter and I am the Chairman of the Associated General Contractors of America's Tax and Fiscal Affairs Committee. I am here today representing the National Construction Industry Council. NCIC consists of the 25 major trade associations and professional societies that together make up America's construction industry. The combined membership of these various NCIC groups and organizations include more than 100,000 contractor firms and 150,000 design professionals.

My testimony today will concentrate primarily on the tax reform provisions which will affect the use of the completed contract method of accounting in the construction industry. Without reservation, and uniformly throughout the industry, we oppose those provisions.

I will also share with you the industry's concerns regarding other provisions of proposed comprehensive tax reform but, unlike our unified opposition to the completed contract changes, will withhold judgment on these other proposed changes at this time.

The $343 billion construction industry's impact on the entire economy is so vast that the industry feels a strong sense of responsibility to minutely examine the tax proposal, to avoid reacting and to be in a position to support all of our ultimate positions with verifiable facts. As a consequence, the industry is undertaking a detailed analysis of the tax reform proposal to determine every aspect of its impact, not only on the construction industry, but also on the entire economy.

The relationship between a sound and healthy construction industry and a sound and healthy economy demands such an approach. Consider these facts:

o The construction industry is the largest goods-producing industry in the country. Whether measuring employment, the value of goods produced (shipments for manufacturing or construction put in place), or what the industry contributes to the gross national product, construction comes out ahead of autos, steel, or any other manufacturing industry.

o The construction industry employed 4.3 million workers in 1984 and the number of workers on industry payrolls has continued to grow, exceeding 4.8 million by June of 1985. In 1984 construction employers provided 4.6 percent of the jobs in the U.S. economy. Another 4.5 percent can be attributed to supplier industry jobs, with an additional 7.8 percent induced in other sectors by the ripple effect of construction activity.

o Construction is an unusually productive industry; because dollars invested in construction are spent on wages, supplies, and materials used in construction. Additional economic growth is created by each $1 spent on construction.

o Although estimates of the economic growth created vary according to the method used to construct the multiplier, each $1 invested in construction adds $2.23 worth of economic transactions to the economy, incorporating payments to suppliers and their payments to other industries, and so on. An estimate of federal construction spending concluded that each $1 invested in the nation's infrastructure added $2.35 to the economy. Over time, each $1 may be responsible for adding as much as $2.80 to the nation's economic potential.

o Over 61 percent of the inputs to the construction process are purchases from other industries while another 30 percent is labor services. Construction, while constituting 8.5 percent of the gross national product on its own, also supports many supplier industries. As much as 14 percent of the gross national product may depend directly or indirectly on construction.

It is a certainty that any changes that adversely impact the construction industry will surge throughout the entire economy.

The industry does not need to reserve judgment, however, on provisions which will affect the use of the completed contract method of accounting in the construction industry.

The Completed Contract Method of Accounting

Background

At the outset, let me be emphatic that the construction industry is not the source of any problems with the completed contract method of accounting. It was used by and widely accepted for the unique nature of the construction industry as the appropriate financial accounting method even before the enactment of the income tax.

Let me be equally emphatic that elimination of the completed contract method of accounting for the construction industry will quickly bankrupt thousands of construction firms and will also have a devastating impact on competition in our industry.

The completed contract method of accounting is a method of reporting income (gain or loss) for tax purposes from long-term contracts. It was first included in Treasury Department regulations in 1918 as the appropriate accounting method for construction contractors following the enactment of the modern business income tax in 1916.

The completed contract method requires a contractor to wait until a contract is finally completed and accepted before reporting a gain or loss from the contract for income tax purposes. The method is the most accurate method for determining gain or loss on construction contracts. The method meets the requirements of the "all events test" for determining income due to the inherent risks and the unique nature of the construction industry. The all events test requires that a taxpayer perform all responsibilities necessary to earn income or realize a loss before it can be declared a gain or loss. The completed contract method mirrors this requirement in recognition of the fact that until a project is completed and accepted by the owner the contractor has no certain claim to either a gain or loss from the contract.

From 1918 to 1976 the completed contract method was limited to construction, building and installation contracts. These are the traditional types of contracts found in the construction industry where the taxpayer builds a single project. They include all forms of contracts for the construction of industrial, highway, and single structures and the various subcontracts required in the construction of the projects.

During the 1960's a variety of other types of contracts attempted to qualify for the completed contract method by judicial interpretation under one of the three traditional categories of long-term contracts. Following this litigation the Treasury Department fully revised the regulations concerning the eligibility and use of the completed contract method of accounting in 1976. A new category of long-term manufacturing contracts was added to the eligibility list for completed contract reporting. As a result of the 1976 regulations, groups now using the completed contract method include construction, shipbuilding, aerospace, weapons manufacturers, heavy equipment manufacturers and a variety of other manufacturers.

The completed contract method has been the appropriate method of reporting income from construction contracts for the last 69 years because of the unique nature and inherent risks of the construction industry. These risks and the unique nature of construction do not permit a contractor to realize any gain or loss from his performance of a contract until it is completed. Only after a contractor performs all his contractural responsibilities can he determine a gain or loss. The unique nature of construction and the inherent risks of construction are as great and significant today as they were 69 years ago.

They include differing sites for each project which are not controlled by the contractor: varying soil conditions; climate conditions; firm prices for the duration of a contract which require the contractor to bind himself to a price before actual costs are known; owner retention policies; changes, modifications or claims during the course of the contract which require the contractor to spend large sums in advance of this contractual right to fully collect contract revenues from the owner; intense competition within the industry which makes profit margins exceedingly small in relation to the total gross contract amount, as well as many other factors. These risks are not found in other industry users of the method. These variables necessitate that profit on a construction contract be reported only after contract completion and acceptance i.e. when gain or loss is known and certain.

Virtually all construction contracts have retainage provisions where the owner retains part of his payments until contract completion. In some instances the retainage arises through a contractual provision for progress billing, in others there is a specific retainage of a percentage of the portion of the contract price. Retainage is ordinarily a very large portion of the profit to be realized, and in most cases is equal to or exceeds the total profit from the contract. Retainages are also often used for corrections or defects after project completion. In all cases, retainage is not released to the contractor until after project completion. Consequently, the profit element of a construction contract is not received until retainage is released.

Recent Regulatory and Legislative History

The completed contract method of accounting was revised by the IRS in 1976. At that time final regulations were published providing specific administrative rules for taxpayers electing the method. All direct and indirect contract costs were specified in the regulations. The regulations also specified which indirect costs are not allocable to a contract. Allocable contract costs are not deducted in the year incurred. These costs are deducted in the year of final completion and acceptance of the contract and are called capitalized contract costs. Indirect contract costs which are not allocable to a contract are deducted in the year incurred and are called period costs. The 1976 rules are still used by virtually all construction contractors and were approved legislatively in the Tax Equity and Fiscal responsibility Act of 1982 (TEFRA). The 1976 rules reflected the 58 years of experience accumulated by the IRS in administering completed contract reporting by the construction industry and are regarded as fair by the industry for reporting income. They are based on traditional accounting principles and reflect basic tax policies of the Code.

The 1976 income tax regulations also expanded the eligibility criteria for using the completed contract method of accounting. Certain long-term manufacturing contracts were made eligible for the accounting method election for the first time. Prior to 1976 only taxpayers performing construction, building and installation contracts could use the method for income tax purposes. After several years the Treasury Department identified a variety of abuses of the method which were found in the administration of the method as it applied to manufacturers. For example, certain contract completion dates were being extended by contract duties which were merely incidental responsibilities. Contracts were also extended by increasing the units to be delivered under the original contract e.g. increase the number of planes or missiles being built. The Treasury also asserted that the cost allocation rules (used to measure gain or loss) did not match items of income and expense accurately. This assertion was made primarily because of exceptional duration manufacturing contracts of 10-20 years which are not found in the construction industry.

The Treasury Department then proposed replacing the completed contract method of accounting in 1982 with a new method of accounting known as the progress payments method. The Treasury also proposed an alternative option of changing the cost allocation rules, contract completion rules, and rules for severing and aggregating contracts. The Treasury dropped its progress payment method of accounting proposal during the legislative hearings preceding the enactment of TEFRA when the construction industry identified numerous flaws in the proposal. Congress then dismissed many of the theoretical positions in the Treasury's alternative recommendations as being inconsequential as they would apply to the construction industry and directed that none of the new cost allocation rules in TEFRA for extended-period long-term contracts be applied to construction contracts lasting less than 36 months or to any construction contractor with less than $25 million in annual gross receipts. In doing so, Congress specifically recognized the differences between industry users of the method by requiring that these revised cost accounting rules for extended-period long-term contracts be applied to all manufacturing contracts lasting longer than 24 months, regardless of the manufacturer's size. The other aspects of the TEFRA completed contract provisions (new contract completion, severing and aggregating rules) did not apply to construction, as the industry pointed out, and no specific exceptions were necessary.

The Administration's recognition of the importance of the traditional use of the completed contract method of accounting in the construction industry went even further than the action taken by Congress in 1982. Following the tax committee mark-up of TEFRA in the Senate Finance Committee, then Secretary of the Treasury, Donald T. Regan wrote to the TEFRA Conference Committee Chairman Rober J. Dole that "After further consideration I am concerned that the Senate provision dealing with the completed contract method of accounting is perceived to have an unnecessarily adverse impact upon the construction industry at this time". If Secretary Regan's recommendation had been acted on there would have been no change at all in the construction industry's use of the completed contract method of accounting.

Current Proposals

The Administration, Senator Bradley and Representative Gephardt, Representative Stark and Senator Roth, have recommended four different proposals affecting the use of the completed contract method of accounting. Each of these proposals was reviewed and rejected by Congress in 1982. The Administration's proposal would apply the extended-period long-term contract cost allocation rules to all construction contracts. The Bradley/-Gephardt hybrid flat tax bill would arbitrarily impose a fictional interest charge on taxpayers electing completed contract. The Stark proposal would prohibit completed contract reporting for long-term Federal contracts and impose the greater tax liability of the progress payment method or percentage of completion method on the contractor. The Roth proposal is similar to the Stark proposal but is limited to Defense Department contracts and exempts a majority of construction contracts from the definition of such contracts.

Administration's Proposal

The President's Tax Proposals for Fairness, Simplicity and Growth contains several proposals concerning income measurement. One part of the proposal is titled "Revised Rules for Production Costs" (Chapter 8.01) which would create a single set of capitalized costs for taxpayers performing long-term contracts, manufacturing inventories, self-constructing assets, growing crops and timber, and extracting minerals. The proposal is based on the earlier Treasury Department Report's theory of tax neutrality. In the abstract this theory requires that the Code not influence the flow of capital to economic activities.

The Chapter proposes to implement the theory of tax neutrality by using the cost capitalization rules used for extended-period long-term contracts for all tax accounting purposes for the multi-period activities described above. The recommendation would have the effect of eliminating the construction contractor (less than $25 million in annual gross receipts) and construction contract (lasting less than 36 months) exemptions added to the Code by TEFRA. The Chapter also recommends adding interest to the list of capitalized costs. Interest was proposed as a capitalized cost by the Treasury in 1982 and dropped by the Department from the proposal early in the legislative process.

The theory of tax neutrality assumes that the value of an asset must not be distorted by the tax system so that investment funds will flow freely. This theory may have some application for taxpayers who can either construct an asset themselves or contract out for its construction. However, the theory is not appropriate to apply to a taxpayer who happens to be in the business of building an asset which he never owns. A taxpayer in the business of building assets is reporting income from that activity and the major policy considerations should be the accuracy and fairness of his reporting method. Whatever the remote influence a contractor's reporting method may have on national capital distribution in the economy is simply insignificant compared to policy considerations of the accuracy and fairness of the taxpayer's method. These policy considerations were incorporated in the 1976 final IRS regulations, confirmed statutorily by TEFRA in 1982 and should not be changed.

The shortcomings of the "neutrality" theory are evident when the major proposed changes in completed contract reporting are examined:

Excess Tax Depreciation

The 1976 IRS final regulations allow a contractor to deduct the excess tax depreciation over book amounts as a period cost. This rule places a contractor using the completed contract method of accounting in the same position as any other taxpayer using an accelerated depreciation method for equipment. Actual equipment cost for the contract is the book value which is treated as a capitalized contract cost. The amount of tax depreciation in excess of book amounts is deducted currently in recognition of the fact that this is not a contract cost. Depriving contractors of this deduction would inhibit equipment acquisitions in the construction industry contrary to the policy of accelerated depreciation.

General and Administrative Expenses

General and Administrative (G & A) expenses are by definition costs not allocable to any particular activity and represent the ongoing nature of the business. The extended-period contract rules requiring partial G & A allocations to contracts are extremely complex. Imposition of this rule on construction contracts lasting less than 36 months or on a contractor with less than $25 million in gross receipts cannot be justified. While abuses of this cost category may be possible in multi-tiered corporate structures when contracts of exceptional duration are performed, this rationale cannot be applied to small construction contractors or to construction contracts lasting less than 36 months.

Pension and Profit Sharing Plan Contributions

The 1976 regulations specifically provide for a current deduction for amounts contributed to pension and profit sharing plans. The regulations clearly reflect the Code's provisions which determine the timing of the deduction for employer contributions to such plans. The Code's provisions are designed to encourage the creation and funding of such plans. The Code provides employers a deduction for the amount contributed to the plans when the contribution is made even though employees do not recognize income until retirement. To qualify for this deduction the employer must have a written plan which establishes the employer's obligations to the plan. Since the President's Proposals do not recommend any change regarding the timing of deductions for contributions to plans in general, the rule for such deductions under the completed contract method of accounting should not be changed either.

Bidding Costs

The 1976 regulations properly recognize that costs incurred in bidding on contracts are not contract costs. While bidding expenses must be incurred to win a contract they cannot be considered contract costs because there is no contract when they are incurred. Although these costs are allocated to extended-period long-term contracts, any extension of the rule to ordinary long-term contracts cannot be justified because there is no overall mismatching of items of income and expense due to exceptional contract durations e.g. 10-20 years.

Interest Expenses

Interest expenses are treated as a current period cost deduction under the 1976 regulations. The Treasury Department voluntarily dropped a proposal to require the capitalization of interest in 1982, yet the new reform proposals again recommend the capitalization of interest.

Interest is a fungible commodity which is not allocable to any contract. Contractors generally borrow funds on the basis of an overall working capital loan. Funds are used on projects as required. For example, if an owner has not made a progress payment when supplies for a project are purchased, funds from working capital are used. The funds may be used for a short period until the progress payment is made. Borrowed funds may also be used on projects where progress payments have been made. Allocating interest expenses in any rational manner in these situations is virtually impossible.

Requiring capitalization of interest expense is also grossly unfair. Any interest income earned as a result of the contract is treated as ordinary income earned currently under the 1976 regulations. For example, if a contractor receives a progress payment which does not require immediate expenditure, he may deposit it in an interest earning account. Any interest income generated by the deposited funds is recognized by the contractor as income immediately. It is unfair to require the contractor to pay tax on interest income and at the same time capitalize interest expense.

Each of these proposed changes to the completed contract cost allocation rules for construction were reviewed and rejected by Congress in 1982. Unlike a taxpayer self-constructing an asset, growing crops or timber, extracting minerals, or manufacturing inventory items, a construction contractor does not own the asset being constructed. There is simply no justification for requiring the contractor's accounting method to reflect the depreciation basis of the constructed asset. The contractor is actively engaged in a business activity and his income reporting method should be based on the income generated by the business. The rules developed by the IRS in 1976 recognize the business activities of the contractor and the policies which should be applied in developing an adequate and fair reporting method.

Proforma Company Example

The National Construction Industry Council has prepared an illustration with accounting assistance of the impact of the Treasury Proposals on a relatively small construction company using the completed contract method (see appendix). The example is based on actual construction company tax and financial information. Construction contracts performed by the example company include building and road contracts. In addition to the completed contract method of accounting proposed changes involving depreciation, investment tax credits, ACRS benefit recapture and corporate rate changes have been factored to estimate the increased tax liabilities the company will incur.

The most significant change in the first year of the proposed changes results from the acceleration of tax payments under the revised accounting rules for the completed contract method of accounting. Under present law the company has a taxable income of $264,248 and a tax liability of $91,524. Changes to the completed contract method of accounting increase taxable income by $331,859 bringing taxable income to $596,107 out of a total of $625,698 when other provisions of the proposals are factored in. This 126% increase in taxable income attributable to the proposed changes in the completed contract method will be amelorated over time as contracts close, however, the example firm's working capital will be permanently reduced by the value of the accelerated tax payments.

The components of the completed contract changes discussed in the preceding sections of this paper comprise the $331,859 increase in taxable income as follows. The rule requiring general and administrative expenses to be allocated to contracts comprises 53% of the increase in taxable income, or $174,801. The elimination of the deduction for excess tax depreciation over book amounts results in 4% of the increase or $14,503. A different mix of equipment or in ratios of equipment to contracts can significantly increase this category's impact. The change in the treatment of profit sharing plan contribution deductions results in 8%, or $27,711 of the increase. Capitalizing bidding expenses on awarded contracts results in $60,109, or 18% of the increase.

The interest expense capitalization requirement results in $54,735 of the increase which is 16% of total.

The other changes in the Treasury proposal result in a $29,591 increase in taxable income. When these increases in taxable income are subjected to the proposed new tax rate schedule and the elimination of the investment tax credit is also taken into account, the construction firm's year end tax liability would increase from $91,524 to $237,026. The percentage tax liability under the Treasury proposal over present law translates into a 259% increase.

Bradley/Gephardt

The Bradley/Gephardt hybrid flat tax proposal contains a provision affecting the completed contract method of accounting. The bill would impose a so-called "look back" interest charge on taxpayers using the method. This provision was briefly embraced by the Treasury Department in 1982 but later dropped.

The look back rule fails to meet the standards of the all events test. This fundamental principle of tax law requires that all events transpire to establish a taxpayer's claim to income (gain or loss). Without this principle taxpayers would be put into a position in which they are taxed on income before they are able to realize its benefit. Until all necessary events occur a taxpayer cannot be required to recognize income because there is in fact no income. Imposing interest over the length of a contract as contemplated by the look back rule under some assumed apportionment formula will only result in a penalty charge for not having income during the period being reported, not a tax on income.

Stark Proposal

The Stark proposal would prohibit the use of the completed contract method of accounting by any taxpayer performing any long-term Federal contract. The taxpayer performing such a contract would be required to use either the progress payment method of accounting or percentage of completion method of accounting. The choice between the two methods would not be elective. Whichever method produces the greatest tax liability for each contract would be required.

The proposed progress payment method of accounting was voluntarily dropped by the Treasury Department in 1982 after the Department was unable to develop the proposal to adequately reflect income. The method would require a taxpayer to include in income all current contract payments in excess of expenditures. This accounting method radically distorts income reporting when a contractor receives a progress payment (such as an advance mobilization payment) before the work associated with the payment begins and reaches the close of his taxable year. This type of billing procedure is common in the construction industry, unlike other industry users of the completed contract method. The contractor receives a portion of the contract price before substantial operations are begun. Once work is fully underway progress payments are made according to the terms of the contract. The owner withholds a percentage of these payments as retention which are released at final completion and owner acceptance of the project. This leaves the contractor in a positive cash flow position at the beginning of the contract and a negative position toward the end of the contract.

The proposed progress payment method of accounting does not reflect income from construction contracts. Progress payments received by a contractor are no more income to the contractor than deposits are to a bank. The contractor has a liability resulting from the receipt of the payment just as a bank has an obligation to release the funds to the depositor. The contractor's liability for the receipt of the payment can be many times greater than the amount of payment because he is responsible for performing his contractual obligations. The cost of performing the contractual obligation is the cost of completing the contract. The Treasury Department could not cure this fatal flaw in 1982 and no substantive aspect of the new proposal corrects the fundamental failure to measure income.

The percentage of completion method of accounting is not widely used to report income in the construction industry because of its failure to reflect the all important principles of the all events test. The percentage of completion method assumes income from a contract is earned throughout the term of the contract. Income is apportioned based on factors such as labor hours or materials installed. This is a fictional estimate which does not correspond to any realistic measurement of assured income. No income is actually realized until the contractor has completed his contractual obligations.

Requiring contractors to report income by using the higher tax liability of progress payments or percentage of completion methods of accounting is grossly unfair. The typical construction contractor will be confronted with widely distorted income tax liabilities on contracts under the progress payments method of accounting. On those contracts where the contractor has expenses exceeding payments, particularly in the earlier stages of contracts, he will be subject to tax on estimates of income which will be earned in the future under the percentage of completion method of accounting. The contractor forced to use the percentage of completion method will almost always be forced to either borrow or reduce working capital to pay these taxes because there will be no contract revenue to pay the tax. Those contracts with unused revenue can be expected to be subject to the progress payment method.

The following examples illustrate the impact of the Stark proposal on two typical construction companies:

Company A is a small general contractor with operating revenues of approximately $4 million in 1981, which increased to approximately $8 million in 1984. Its condensed balance sheet at December 31, 1981 is as follows:

CONDENSED BALANCE SHEET
Company A
December 31, 1982

Current Assets	$870,000	Current Liabilities	$700,000
Other Assets	61,000	Shareholders' Equity	231,000
Total Assets	$931,000	Total Liabilities & Equity	$931,000

At December 31, 1982, the company had a contract which was 40 percent complete and had received payments in excess of contract costs of $245,000, which under the progress payment method would have resulted in taxes payable of approximately $112,000. During calendar year 1983, the contractor encountered severe problems with the project which resulted in projected significant losses in 1983 and 1984, culminating in a total loss of $940,000 at December 31, 1984. Also during 1983 the contractor began work on additional projects and at December 31, 1983, the condensed balance sheet is as follows:

CONDENSED BALANCE SHEET
Company A
December 31, 1983

Current Assets	$1,400,000	Current Liabilities	$1,274,000
Other Assets	1,000	Shareholders' Equity	127,000
Total Assets	$1,401,000	Total Liabilities & Equity	$1,401,000

At December 31, 1983, the company had another project on which payments in excess of cost equaled $575,000 which under the progress payment method would have resulted in an additional tax payable of approximately $265,000.

Under the proposed progress payments method, the contractor would have paid taxes as follows:

December 31, 1982	$112,000
December 31, 1983	265,000
	$377,000

At this point in time, the contractor cannot pay the income taxes out of the company's working capital, which is now negative, and cannot get a loan based on the financial statements of the company. The company is, in fact, probably out of business.

Under the progress payments method, the Balance Sheet would appear as follows:

Company A
Condensed Balance Sheet
December 31, 1985

Current Assets	$1,023,000	Current Liabilities	$1,162,000
Other Assets	1,000	Shareholders' Equity	(138,000)
Total Assets	$1,024,000	Total Liabilities & Equity	$1,024,000

At December 31, 1983, there is no accrual for Federal Income Taxes in the financial statements. The payment of an additional $265,000 in Federal Income Taxes now results in a Shareholders' Equity deficit of $250,000 ($127,000 - ($112,000 + $265,000)) and a negative working capital of $251,000 ($1,023,000 - $1,274,000).

Fortunately, the completed contract method more accurately reflected the results of all contracts, and the company paid no taxes in 1982 and 1983. The company was able to survive and during calendar year 1984 had operating revenues of approximately $8 million on which it was able to derive acceptable profits.

COMPANY B

Company B has a deferred tax liability of $5 million of which under the completed contract method $2.5 million is payable at the end of its current fiscal year. Company B also has a net worth of $6 million and working capital of $8 million. A bonding company considers net worth and working capital in determining the amount of work in progress it will permit Company B. The bonding company also considers deferred taxes not to be paid in the current year as a reduction in current liabilities, thereby increasing working capital. In this instance, $2.5 million not due in the current year is deducted from current liabilities, increasing working capital by $2.5 million, from $8 million to $10.5 million. The bonding company will allow $20 of work in progress for each dollar of working capital. Under these circumstances, the bonding company will permit work in progress of $210 million ($10.5 million times 20); however, if under the percentage of completion or the progress payment method, Company B must pay an additional $2.5 million in income taxes, then the bonding company will in this case reduce the amount of work in progress allowed approximately $50 million ($2.5 million times 20) or from $210 million to $160 million.

In a work program consisting of $210 million, work in progress, total operating revenue for a fiscal year would be in the range of $150 million and if the general contractor is doing 40 percent of the work with his own forces, the contractor would be employing approximately 800 employees. If the contractor's volume is thus reduced approximately 25 percent ($50 million divided by 210), then 200 of his 800 employees would become unemployed. Likewise, the approximately 1,200 subcontract employees would be reduced by 300 employees.

The reduction in the work force of the general contractor and of the subcontractor does not take into account the ripple effect on the hundreds of material and service suppliers to the general contractor and the subcontractor.

Roth Proposal

The Roth and Stark proposals are similar but Senator Roth's completed contract bill contains some significant differences. The Roth proposal would prevent the use of completed contract reporting for Department of Defense contracts rather than all long-term Federal contracts. In addition, ordinary long-term construction contracts (i.e. less than 36 months or performed by a contractor with less than $25 million in gross receipts) are exempted from the definition of Defense contracts.

The construction industry's opposition to the Roth bill is based on the limited construction contract exemption. Extended-period long-term construction contracts will be subject to the same income distortions as ordinary construction contracts under the percentage of completion/progress payment accounting combinations proposed in both bills. NCIC's recommendation regarding the Roth proposal is to revise the construction contract exemption to cover all construction contracts.

Conclusion

The completed contract method of accounting is the fairest and most equitable method of reporting income from long-term construction contracts because of the unique nature and inherent risks of construction. There is no justification for revising the present administrative rules for the method which were based on 58 years of IRS experience with the method when published in 1976 as final regulations and legislatively recognized by Congress in 1982. All current proposals to revise the use of the method in construction were reviewed in 1982 and rejected by either the Treasury or Congress as unworkable, or contrary to sound tax policy and should be rejected again.

Other Tax Reform Provisions

Although reserving judgment as to opposition or support of the remainder of the tax reform proposal, we would be remiss if we did not share with the committee the following concerns regarding other tax reform provisons.

Accelerated Cost Recovery and Investment Tax Credits

The President's tax reform proposals recommend replacing the accelerated cost recovery system (ACRS) and investment tax credits (including credits applicable to real property improvements such as the rehabilitation and energy credits) with a new depreciation schedule called the capital cost recovery system (CCRS). The new CCRS depreciation formula applies different percentages to classes of assets in determining annual depreciation amounts. The cost or basis of the assets is adjusted for inflation each year before the depreciation percentages are applied. While CCRS depreciation amounts are similar to ACRS amounts, the proposed CCRS system falls short of the ACRS/ITC combination.

The combination of ACRS and the rehabilitation tax credit provides a clear example of how the CCRS system falls short. The credit ranges from 15, to 25 percent of rehabilitation expenditures while the building's cost basis, after being adjusted for the credit, can be recovered over an 18 year period. Under CCRS the building's cost basis would be recovered over a 28 year priod. During the 28 year recovery period 4 percent of the inflation adjusted cost basis of the building would be deducted currently. This allows for larger inflation adjusted deductions in the latter portion of the recovery period than in the early part of the period. The investors must wait a longer period to have their investment costs recognized by the tax system and receive no credit for rehabilitation expenditures at all. This scenario will greatly reduce the incentives of investing in rehabilitation projects. The reduced construction of the projects will be felt in more established urban areas where most rehabilitation projects are conducted.

The use of CCRS will have effects in other construction markets as well. Projects requiring extensive equipment installations will suffer more than those where the structure is the primary subject of the contract. The loss of the ITC will affect the cost of the equipment to be installed and is the difference between present law and the proposed changes.

The CCRS is expected to adversely influence investment decisions. ACRS allows for recovery of capital investments over a shorter period of time than CCRS. The CCRS inflation index, and longer recovery period will make long-term investments more speculative.

NCIC's Proforma Co. example (see appendix) incorporates the changes to equipment depreciation and loss of the investment tax credit. While the Administration's proposal would increase the depreciation amounts for equipment by $3,418 (a benefit to the taxpayer), the loss of the investment tax credit increases the taxpayer's actual tax by $9,780. In addition, the benefit of acceleration would be curtailed by the change in accounting rules proposed for taxpayers electing the completed contract method of accounting by mistiming the deduction for the excess tax depreciation over book amounts.

ACRS Benefit Recapture

The Administration's proposal would include 40 percent of a taxpayer's "excess depreciation" taken between January 1, 1980 and July 1, 1986 in income over a three-year period. So-called excess depreciation is the difference between depreciation and amortization deductions claimed and the amount of depreciation which would have been allowed under a straight-line depreciation method. This rule applies to taxpayers with $400,000 or more in depreciation deductions. The first $300,000 of deductions are exempt from this provision. Twelve percent of the 40 percent is included in income in 1986 and 1987 and 16 percent in 1988.

As the NCIC Proforma Co. example illustrates, the construction firm's taxable income would increase by $33,009 in 1986 as a result of this provision. The obvious negative consequences of an increased tax liability resulting from this arbitrary recapture rule is only one of the concerns regarding this proposal. Recapturing capital recovery amounts will prevent taxpayers from ever having any certainty in the tax consequences of prior transactions.

The ACRS recapture rule will not directly effect the tax liability of construction projects begun after December 1, 1986. However, investors will take into account the possibility of such a change in the future in calculating the present value of their investments. Investments in real estate are particularily susceptible to a reduced present value calculation because of the lack of a positive cash flow from most real estate investments in the early stages of the project and the long period of time for holding real property investments. For example, the value of an investment in real estate will have to reflect the possibility of having tax benefits included in an investor's future income. The present value will be dramatically affected because there is no sale of the property and little or no cash flow from the investment to pay the tax liability resulting from the inclusion of prior tax benefits in the investor's income. Investors must assume that other income sources will have to be used to pay the recapture tax if such a proposal is ever again incorporated into the law.

Cash Method of Accounting

The Administration proposes to prohibit the use of the cash method of accounting with respect to a trade or business unless both of the following conditions are met:

(1) the business has average annual gross receipts of $5 million or less; and,

(2) no other method of accounting has been used to determine income, profit, or loss of the business for the purpose of reports or statements, or for credit purposes.

Although the completed contract method of accounting is the dominant method used in the construction industry, cash accounting is also used. For example, engineering and architectural contracts are not eligible for completed contract reporting.

Small firms, (exceeding $5 million in annual receipts) use the method as an election for all accounting purposes.

The cash accounting method is a fundamental accounting method and a necessity. It is simply unfair to restrict its use and put taxpayers in a position where they must pay tax on income before they receive the cash benefit of that income.

Foreign Tax Credit

The original Treasury Department recommendation to impose a per country limitation on the foreign tax credit (FTC) is reproposed in the Administration's tax proposals. The carryover period is proposed to be extended from 5 to 10 years. No change in the FTC carryback period of 2 years is proposed, despite the explicit acknowledgement in the proposal that an extension is reasonable. In addition, new income "sourcing" rules are proposed in the President's report to deal with the foreign technical assistance tax problem found in international construction. A per-country election to either deduct (when there is no foreign income) or credit foreign taxes is also proposed.

The per-country limitation would limit credit amounts to taxes and income earned in individual countries. U.S. contractors compete in countries where they are able to win contracts, the location of job sites cannot be chosen for tax planning purposes and any restrictions on offsets for taxes paid in countries where jobs are performed cannot be justified.

Limiting Travel and Expense Deductions

The Administration proposes treating travel assignments extending beyond one year as "indefinite", thereby denying any travel deduction for such job assignments. This proposal would reverse a recent IRS ruling which extended the possible time for "temporary" job assignments to two years under a variety of safeguards. These safeguards are requirements which are not applicable to the traditional test of a temporary assignment.

AGC believes the present IRS rules for determing whether a job assignment is temporary or indefinite reflect the business realities of the construction industry and should be maintained. Both management and labor construction personnel are required to travel to job sites. These sites are frequently long distances from employees' homes and assignments can be for substantial periods. It is unfair to deny employees a deduction for expenses incurred for living at the sites. The expenses are incurred as a result of the employees' income generating activities and would not have been incurred absent the business necessity. The proposed rule would treat these expenses as personal when the employee is already paying the expenses of maintaining his real personal residence.

Fringe Benefits

The President's report recommends including the first $10 per month and $25 per month of individual/family health plan coverage in an employee's gross income. The present $5,000 exclusion for employer provided death benefits would also be repealed. Uniform nondiscrimination rules are also proposed to cover a wide variety of employer provided benefits such as life insurance, health benefits, and educational assistance programs. New limits on contributions to cash deferred compensation plans would be imposed if individual retirement account contributions exceed certain levels.

NCIC believes the policy of encouraging the creation of employer sponsored fringe benefit programs is better reflected by present law than the proposed changes. While preferable to the original Treasury Department recommendation to cap employee health coverage, the new proposal does not enforce the policy of encouraging the creation of employer sponsored fringe benefit plans.

The proposed repeal of the $5,000 exclusion for employer provided death benefits limits an employer's ability to structure a benefit program which meets the needs of the employees. Death is a tragic event for most families and frequently generates economic problems for the deceased's surviving family. Taxing the first $5,000 of employer provided death benefits only amplifies economic problems faced by the family survivors.

The imposition of harsher nondiscrimination rules in all types of employer provided benefits will only serve to discourage the creation and funding of such plans and restricts an employer's ability to structure benefits to meet employees' needs. Requirements which impose burdens on employers in providing benefits will only serve to limit the benefits provided because the employer can either forego the expense totally or compensate the employees for the value of contributions which would have been made. Employees will then be put in a position of obtaining benefit program equivalents with after tax compensation.

Municipal Bonds

The President's report recommends the elimination of the tax-exempt status of interest earned on bonds issued by state and local governments for "private purposes". These bonds are typically used to finance housing, transportation, commercial and industrial development within the bond issuing jurisdiction. Municipal bonds would lose their tax-exempt status if more than 1 percent of their proceeds are used directly or indirectly by any person other than a state or local governemnt. An exception is provided if the facility is used by the general public.

Denying tax-exempt financing for so-called private purpose facilities is not sound tax policy. The volume of industrial development tax-exempt financing is already subject to state-by-state volume limitations based on population. In addition, bond issues must be approved by local legislative bodies. Local jurisdictions are in the best position to determine what types of facilities are in the interest of their local constituency. Some facilities which are undeniably private are clearly in the public interest as well. For example, a rural community may decide that a retail shopping facility is critical to the economic expansion of its area. The reduced interest expense of tax-exempt financing can be the difference between deciding to build a facility or foregoing such a facility. Eliminating the tax-exempt status of such bonds can have a severe detrimental impact on necessary infrastructure development.

State and Local Tax Deductions

The President's proposals recommend that the deduction for state and local taxes not incurred in a trade or business be repealed. These taxes include state and local real and personal property taxes, income taxes and general sales taxes. The reason given for the proposal is to eliminate any "federal subsidy" for local public services such as public education, road construction and repair, and sanitary services.

NCIC believes the deduction for state and local taxes is based on sound tax policy considerations. State and local taxes are deducted to avoid the imposition of double taxation of income. AGC has great concern that implementation of this provision will prevent necessary investment in state and local infrastructure.

Possessions Tax Credit (Section 936)

The Administration's proposal adopts a Treasury Department recommendation that will dramatically affect construction activities in U.S. possessions, particularly in the Commonwealth of Puerto Rico . The possessions tax credit (Section 936) has provided significant impetus to local economies in U.S. possessions. The substitute wage credit in the proposal fails to compensate for the credit's repeal. NCIC believes that repeal of the credit will have dramatically negative effects on construction activities in the U.S. possessions.

Capital Gains

The Administration's proposal to reduce the current capital gain exclusion from 60 to 50 percent is an improvement over the original Treasury Department recommendation to eliminate all capital gains. However, NCIC is concerned about the restrictions on capital gain eligibility. Property used in an active business is not eligible for the exclusion unless the asset is land. These restrictions will prevent investors in limited partnerships from obtaining capital gain treatment on the sale of structures. Limited partners are owners of the property held by the partnership but do not have active management rights. This clearly distinguishes them from owners of active businesses. NCIC does not believe that limited partners should be considered investors for capital gain treatment.

At-Risk Limitations

The Code's at-risk rules have never been applied to investments in real property. Under current law investors in real estate syndications are allowed the full depreciation benefits of the cost of a structure without regard to the recourse liability of mortgage notes. Investors in personal property are subject to maximum depreciation amounts based on their personal liability under the at-risk rules. This difference in treatment prevents valuation manipulations which can occur under a variety of situations in personal property investments. Such value manipulations are not applicable to real estate investments since they can be accurately valued. Manipulating the valuation on buildings is simply not an existing problem. The imposition of the at-risk rules to investments in real property will require investors to assume liabilities which are not required for business ownership purposes and significantly reduce the attractiveness of investments in real property.

Interest Expense Limitation

The President's Report proposes to limit all personal interest deductions, except for mortgage interest deductions for a personal residence, to $5,000 per year over investment income. Interest subject to the investment interest limitation includes: (a) all interest not incurred in connection with a trade or business, (b) the taxpayer's share of all interest expense of Subchapter S corporations unless the taxpayer actively participates in the corporation, and, (c) the taxpayer's distributive share of interest expense from limited partnerships.

Limiting interest expense deductions will prevent many taxpayers from investing in long-term capital projects even though the expense incurred is clearly related to an income producing activity. A distinction between taxpayers based on existing income is inequitable because it does not provide the same tax treatment for identical investment activities.

NCIC is also concerned that the $5,000 annual limitation will prevent individuals capable of leveraging from investing in real estate ventures. Investors borrowing to invest in a partnership will be prevented from deducting interest expenses if the expense exceeds the $5,000 annual deduction limit. Those investors who are able to leverage their personal residence will be able to raise additional investment funds but will have to have paid off a portion of the original mortgage if they are to qualify under the fair market maximum limitation. This will be difficult for individuals in some states which restrict second mortgages on "homestead properties". The rule also works against high income individuals who either do not own homes or own homes with insufficient equity to raise additional investment capital.

Construction Period Interest

The Administration proposal would require the capitalization of interest expenses by a project owner for both self constructed assets and assets constructed by contract, if the construction period is longer than two years. Interest expenses incurred throughout the construction period would have to be capitalized. This construction interest capitalization requirement will prove to increase the cost of construction. As indicated in the Administration's explanation of the proposal, interest expense is a significant component of long-term construction costs that generally is not required to be capitalized under present law.

Corporate and Personal AMTs

The inclusion of 20% Alternative Minimum Taxes (AMTs) on both corporations and individuals will reduce the intended benefits of the proposed capital cost recovery system (CCRS).

Solid Waste/Mining Reclamation Costs

Expenses that will be incurred in the future cannot generally be deducted currently, even if the existence of the liability can be established with certainty. Cash method taxpapers deduct expenses when paid. Accrual method taxpayers accrue expenses when economic performance giving rise to the expense occur. However, pursuant to a statutory exception to these general rules to the economic performance requirement, taxpayers may take current deductions associated with certain mining and solid waste disposal site reclamation and closing costs. These amounts are added to a reserve account. After reclamation activities are concluded actual costs are compared with reserve costs and any additional costs are deducted or excess reserve deductions added back to income. These special rules lower the cost of these special activities. The proposed repeal of this rule will result in a corresponding increase in costs and disincentive to invest in such needed activities.

Summary and Conclusion

o The entire construction industry is unalterably opposed to proposed changes to the completed contract method of accounting for construction.

o The current proposed changes to completed contract reporting for construction were fully reviewed by Congress and rejected during the legislative process preceding the enactment of the Tax Equity and Fiscal Responsibility Act of 1982, and must again be rejected.

o Because of the beneficial ripple impact of construction throughout the entire economy, it is a certainty that any changes in tax laws that adversely impact the construction industry will surge throughout the entire economy with rippling adverse impacts on other industries that are dependent on the good health of the construction industry.

STATEMENT OF JOHN S. NOLAN, ATTORNEY, MILLER & CHEVALIER, WASHINGTON, DC; ON BEHALF OF THE AEROSPACE INDUSTRIES ASSOCIATION

Mr. NOLAN. Thank you, Senator Packwood. I am John Nolan, counsel to the Aerospace Industries Association, and I appear today to address the tax reform proposals dealing with the completed contract method.

There is widespread misunderstanding that the completed contract method is currently resulting in unduly low effective tax rates on the aerospace industry. This is not correct. As a result of extensive changes to the completed contract method made in the Tax Equity and Fiscal Responsibility Act of 1982, TEFRA, which changes were developed in this committee, the aerospace industry is currently paying substantial and increasing effective tax rates.

My firm recently collected data from seven major defense contractors using the completed contract method; these seven major companies represent a large part of the defense industry. The data show that these seven companies paid an effective tax rate of 24 percent in 1984, which will increase to 27 percent in 1985, and then gradually to 39 percent by 1988.

Even these increasing tax rates do not tell the whole story. If the tax liabilities of the seven companies are computed without taking into account net operating loss carryovers, the effective tax rates are 41 percent in 1984 and reach 42 percent in 1988. These are more realistic numbers in judging the real effects that the TEFRA changes in the completed contract method have had and will have effective tax rates on aerospace companies.

Aerospace companies have suffered substantial real losses, and to the extent this reduces effective tax rates, it has nothing to do with the completed contract method. These have included large losses on commercial airplane programs, because of foreign government-subsidized competition. There have also been substantial real losses on defense contracts. It is another popular misconception that defense contracts always result in profits. Nothing could be further from the truth. Weapons system contracting is often very risky. For example, Grumman lost $260 million on the F-14 fighter; Lockheed lost $484 million on a group of contracts that include the C-5A contract, and General Dynamics lost $359 million on the SSN688 class submarine.

Finally, the fact that General Electric has paid no taxes has nothing to do with the completed contract method. GE does not use the method.

The major changes in the completed contract method in TEFRA were estimated to increase taxes of companies using the method by $10.6 billion in the years 1983 to 1987. The data show that this is actually happening.

The President's tax reform proposals would further tighten the rules for the completed contract taxpayers. These proposed changes would result in an additional tax burden of $18.4 billion on completed contract taxpayers over the years 1986 to 1990 above and beyond the $10.6 billion tax increases imposed on completed contract taxpayers by TEFRA. While we criticize some of the specifics of the President's proposals in my written statement, by and large, the aerospace industry is prepared to accept those changes.

The President's proposals in this area will ensure that completed contract taxpayers will pay very substantial effective tax rates. There is no need for this committee to go beyond the President's proposals.

The completed contract method is the only sound tax accounting method to deal with the high degree of uncertainty of the extent of profits or losses on long-term contracts for high-technology products. These exceedingly complex contracts are always pushing the state of the art, involve hundreds, even thousands, of technological changes as production progresses, and are extremely labor intensive, often requiring intricate fabrication and assembly of hundreds of thousands of individual parts or pieces over a period of many years. It is impossible to know whether and to what extent profits or losses are suffered on a year-by-year basis. It is important to recognize that the completed contract method defers the allowance of losses as well as the determination of profits until the contracts are completed. Neither profits nor losses can be determined until the completion of each contract.

Proposals for using the percentage of completion method for tax purposes will not work, even though it is often used for financial accounting purposes. The percentage of completion method in any form necessarily depends upon estimates which are far too subjective and uncertain for tax purposes. Furthermore, if they require reporting of profits each year simply because costs have been incurred, but defers losses in any event until completion, as most such proposals would do, they are unsound and unfair.

Accordingly, Mr. Chairman, we urge this committee to consider the President's proposals to tighten up the completed contract method in light of our specific comments. The committee should retain the basic structure of the completed contract method with some such further changes. This is entirely proper in view of the fact that aerospace companies are already paying substantial effective tax rates because of the TEFRA——

The CHAIRMAN. I will have to ask you to conclude, Mr. Nolan.

Mr. NOLAN. I will. And would pay even higher effective tax rates with changes such as those proposed by the President. Thank you very much.

The CHAIRMAN. Is GE using the percentage of completion method?

Mr. NOLAN. GE does not use the percentage of completion method. They use, I think, a standard accrual method of accounting. The reason that their tax rates are so low is that they were a participant in the safe harbor leasing scheme that was adopted several years ago.

The CHAIRMAN. I am familiar with why they are low, but you indicate they didn't use the completed contract method, and I was curious as to what they are using.

Mr. NOLAN. I think they use standard accrual accounting methods.

The CHAIRMAN. On page 4 of your testimony, you have listed the book income before tax and the tax liability before credits of the major aesospace companies for the years 1981 to 1988. Do you have the tax liability after credits?

Mr. Nolan. Yes, we can supply that data.

The Chairman. Do you happen to have it now?

Mr. Nolan. Part of the reason that we haven't submitted that, or put that information in the data, is that we can't anticipate what credits are going to be for future years because the President, of course, has proposed repeal of the investment credit. Accordingly we had to determine the tax liabilities in our projections on the assumption that there would be no credits. We could provide information on past years.

The Chairman. What about 1982, 1983, 1984? You have tax liabilities before credits for those year as well. I would be curious if you would supply the tax liability after credits for those years.

Mr. Nolan. We can certainly provide that information, but of course, credits have nothing to do with the completed contract method. They are adopted for a different legislative purpose.

The Chairman. I understand that.

[The prepared information on credits follows:]

Statement of
The Aerospace Industries Association
Submitted to the
Committee on Finance
For the Record of Public Hearings on
The President's Tax Proposals
As To The Completed Contract Method
Of Accounting

October 4, 1985

Completed Contract Method -- President's Tax Reform Proposals.

The most direct effect of the President's proposals on the aerospace industry derives from the proposed new rules for treatment of production costs. Most but not all aerospace companies utilize the completed contract method.* Section 8.01 of the President's proposals would require that the extensive rules for capitalization of costs allocable to "extended-period long term contracts" adopted in 1982 be extended to other long term contracts, to the determination of inventories in general, and to the cost of self-constructed assets. Further, section 8.01 would require that all general and administrative expenses "attributable to certain cost-plus and Federal government contracts" be capitalized. Interest expense would also be capitalized with respect to property with a production period of two years or longer.

The President's proposals would have major effects on the completed contract method in addition to those already presently taking effect under TEFRA. Over the five years 1986-1990, they are estimated to increase the tax burden on completed contract taxpayers by an additional $18.4 billion, over and above the $10.6 billion tax increase for the years 1983-1987 as a result of changes in the completed contract method in TEFRA in 1982.

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* General Electric Company, a major supplier of aerospace engines, does not use the completed contract method.

The significance of these proposals requires an understanding of the action taken by Congress with respect to long term contracts in the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA). The Administration recommended repeal of the completed contract method in early 1982. Congress examined the matter thoroughly during the development of TEFRA and decided that instead of repealing the completed contract method, a new set of rules governing its use should be adopted. Section 229 of TEFRA gave broad authority to Treasury to issue regulations governing use of the method, and the legislative history provided guidance with respect to rules to be adopted. S. Rep. No. 530, 97th Cong., 2d Sess. 547 (Aug. 17, 1982) Conference Report to Accompany H.R. 4961. See also General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982, Joint Committee on Taxation 148 (1982).

These provisions were developed by Congress to set forth new rules as to when long term contracts were to be deemed completed to insure that income would be reported without undue deferral. The new rules provide for the severing and aggregation of contracts to prevent undue benefit. Most importantly, the new rules provide for the allocation of many additional costs to long term contracts. Thus, these latter rules require extensive capitalization of costs, so that such costs may ultimately be deducted only when contracts are completed and the gross income is reported. General and administrative expenses properly allocable to long term contracts, for example, must be capitalized. Many other specified costs must also be capitalized. Interest expense and general and administrative expenses attributable to overall management and policy guidance of the corporation, may, however, continue to be treated as period costs, currently deductible as incurred.

The Treasury Department has developed comprehensive new regulations under TEFRA to implement these rules. These regulations will insure that the problems that arose in the application of the completed contract method cannot recur.

The new cost capitalization rules went well beyond prior law and were phased in, to take effect one-third in 1983, two-thirds in 1984 and fully in 1985. Because these provisions were phased-in their full revenue effect has not, as yet, become fully evident. The provisions were estimated to increase revenues by $882 million in 1983, $2,235 million in 1984, $2,535 million in 1985, $2,390 million in 1986, and $2,559 million in 1987.

We have recently compiled data from seven major defense contractors who use the completed contract method of accounting. These companies represent a significant segment of the aerospace industry. They have reported over $7 billion in pre-tax financial earnings over the past three years and have projected pre-tax earnings of over $16 billion for 1985-1988.

The data compiled clearly reflect that TEFRA has had a major effect on the taxation of defense contractors who use the completed contract method of accounting. The seven surveyed companies have projected on the basis of the current 46 percent tax rate that their total federal income tax before credits will be $5.3 billion for 1985-1988. This equates to an effective rate of tax of 33 percent on their $16 billion of pre-tax earnings. Table I reflects book earnings and tax liability before credits for 1982 through 1988.

Table I

Combined Effective Tax Rates for
Seven Major Aerospace Companies
1982-1988
(dollars in millions)

Year	Book Income Before Tax	Tax Liability Before Credits	Effective Rate of Tax
1982	$1,682	$120	7%
1983	2,423	360	15%
1984	2,956	704	24%
1985	3,550	959	27%
1986	3,859	1,022	26%
1987	4,178	1,582	38%
1988	4,420	1,736	39%

Table I shows an effective pre-TEFRA rate of tax of 7 percent increasing to a post-TEFRA rate of tax in 1988 of 39 percent. This reflects a conservative picture of the real effect of TEFRA because it presents computed tax liabilites after the net operating loss deduction. Net operating losses realized prior to 1982 are not reflected in the book income figures for 1982-1988. This procedure reduces the effective rate of tax on book income reflected in Table I. Table II, set forth below, adjusts for net operating losses and reflects the effective rate of tax before the net operating loss deduction. Table II compares the current year's financial income to the current year's taxable income and reflects the effective rate of tax before the net operating loss deduction and credits.

Table II

Combined Effective Tax Rates for Seven Major Aerospace Companies Before Pre-1982 Net Operating Losses

1982-1988

(dollars in millions)

Yea	Book Income Before Tax	Tax Income (Loss) Before NOL	Effective Rate of Tax (1)
1982	$1,682	$(801)	-0-
1983	2,423	1,332	25%
1984	2,956	2,655	41%
1985	3,550	2,157	28%
1986	3,859	2,550	30%
1987	4,178	3,988	44%
1988	4,420	4,022	42%

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(1) The effective rate of tax is computed by applying a 46 percent tax rate to taxable income before NOL and dividing the derived amount by book income before tax.

Table II graphically depicts the major changes made by TEFRA which result in a substantial increase in income reported from long term contracts. The seven major defense contractors surveyed also provided data which reflect that as a direct consequence of TEFRA they will report in excess of an additional $6 billion in taxable income through 1988.

As previously stated, the President's 1985 tax proposals would extend these TEFRA cost capitalization rules still further and would require interest expense to be capitalized in many cases. The President's proposals would have the practical effect of requiring that virtually all general and administrative expenses of Federal government contractors be capitalized except to the extent they could be properly attributed to commercial (non-government) business.

The proposals are somewhat ambiguous as to the treatment of research and experimental costs, which are specifically deductible under Code §174; unsuccessful bid and proposal costs, which are closely related to research and experimental costs; and marketing, selling, and advertising costs. Marketing, selling, and advertising costs have traditionally been treated for tax and financial accounting purposes as period costs, deductible as incurred, rather than product costs, to be capitalized as inventory or long term contract costs and treated as cost of sales only when the related revenue is included in income.

It is inappropriate to require Federal contractors and cost-plus contractors to capitalize general and administrative expenses that are not capitalized by other contractors. The rationale used in the President's proposal to support this special treatment of certain contractors is that Federal and cost-plus contractors are paid for such overhead costs as part of the contract price. This is not a distinguishing feature of

Federal contracts or cost-plus contracts. All contractors generaly seek to recover all business costs plus a profit when determining a contract price. Furthermore, it is wrong to assume that Federal contractors and cost-plus contractors recover all costs. Many Federal contracts result in major losses, as hereinafter described (p. 11). Furthermore, certain costs are not allowed under Federal contracts. For example, interest expense and many advertising costs are not included in allocable overhead.

Providing special capitalization rules for Federal contractors and cost-plus contractors is inconsistent with the goal of the President's proposal to provide uniform rules for the capitalization of production costs to make the tax code more neutral in its application to various business activities. Under the rationale used in the proposal businesses that manufactured products for future sale to the Federal government would be given an economic advantage over businesses that manufactured products under a contract with the Federal government.

It is also inappropriate to capitalize interest. The proposal to capitalize interest creates a distortion of income. Taxpayers who invest in long term projects can either invest their own funds or borrow funds. To the extent they invest their own funds they forego income that would otherwise be earned if the funds were invested. Their taxable incomes are lower and no costs are capitalized. Under current law, taxpayers who borrow to invest in long term projects are in a comparable economic position. They deduct the interest cost currently instead of reporting lower income and capitalize no cost. Under the President's proposal this parity would be lost. The taxpayers who borrow would not be permitted the current deduction, but would be required to capitalize the cost of borrowing. Taxpayers who invest their own funds would not capitalize any cost of funds. Goods produced by taxpayers who borrow capital would become more expensive even though their actual non-tax costs remain the same. The tax system should not discourage businesses from borrowing to expand their business activity.

B. Senator Roth's Proposal (S. 1281).

Senator Roth has introduced a bill which would eliminate the completed contract method. It would require that with respect to Defense Department long term contracts only, contractors would be required to include in gross income the greater of -- (1) the aggregate amount received under any such Defense Department contract; or (2) the amount determined under the percentage of completion method. Construction contracts to be completed within 3 years, and contracts performed by businesses with annual gross receipts of less than $25 million, would not be subject to this rule.

In introducing the bill, Senator Roth stated that the contractor "could claim any corresponding deductions associated with the income." Senator Roth did not explain how these deductions would be determined, however.

This difficulty in determining costs of a long term contract in the early stages of its performance is the very reason why use of the completed contract method is necessary. It is impossible to determine the costs to be associated with gross receipts on contracts involving production over a long period of years of highly-complex products which are constantly pushing the state of the art, even during the production cycle. Frequently, Defense Department contracts are in development and production over a span of years, during which time many thousands of changes in technology may be developed and incorporated into the product.

There are enormous uncertainties as to profit or loss: Grumman lost $260 million on the F-14 fighter; Lockheed suffered large losses on four weapons systems contracts for the C-5A, Cheyenne Helicopter, SRAM missile motor, and certain ships, the final costs and contract prices of which were settled as a package for a fixed amount of loss of $484 million in 1970; General Dynamics lost $359 million on the SSN688-Class submarine. There are scores of other dramatic examples that demonstrate the extreme difficulty, if not impossibility, of determining the actual profit or loss on defense contracts until substantial completion has occurred.

These uncertainties are not new. Congress should not ignore the history of the completed contract method of accounting which has been sanctioned by Treasury Regulations since 1918. In subsequent years it was used as the means of resolving substantial controversy over the use of estimates in determining income and in the treatment of advance or progress payments for goods to be delivered in the future, issues which particularly affected the construction, shipbuilding, and aerospace industries. The possibility of large losses on long term contracts by manufacturers using the accrual method of tax accounting led these manufacturers to seek loss deductions under the lower-of-cost-or-market inventory convention available to accrual basis taxpayers, and the courts allowed these losses. Space Controls, Inc. v. Commissioner, 322 F.2d 144 (5th Cir. 1963); E. W. Bliss Company v. United States, 351 F.2d 449 (6th Cir. 1965).

Many controversies also developed between the IRS and the aerospace industry as to the use of the accrual method. For financial accounting purposes, the industry to a substantial degree averaged its cost of sales upon deliveries over the entire number of units under a defense contract, or commercial airplanes under a "program" to build a given model. This reflected the fact that the construction of the initial airplanes, missiles, or space vehicles results in a much higher unit cost than subsequent units. Direct labor costs in this highly labor-intensive industry reflect the intricate fabrication and assembly of hundreds of thousands of individual parts or pieces for any unit. These direct labor costs follow a "learning curve" as production proceeds from one unit to the next under the contract or program. Material costs reflecting spoilage, and tooling costs to some extent, follow the same pattern. The product is priced under the defense contract or commercial airplane program on a unit basis which reflects an averaging of these major costs, and financial accounting often follows the same concepts to determine profits or losses as units are delivered.

For tax purposes, however, the initial high level of costs of units delivered could be deducted on the accrual basis as deliveries of these initial units occurred. The costs actually had been incurred. At the same time, these abnormally high costs, which would result in large losses if deducted, would normally be recovered in the price of units to be subsequently delivered under existing contracts. Some companies deducted the high costs attributable to the initial units as they were delivered. Other companies followed their financial accounting treatment and averaged their costs over their defense contracts or commercial airplane program on a contract-by-contract or program-by-program basis. This averaging, however, necessarily involved the estimation of future costs of production under the contract or program in determining the costs to be deducted on the delivery of the early units.

The Internal Revenue Service was unhappy with either alternative -- one involved the deduction of losses that could be said to be unrealistic, and the other involved the extensive use of "estimates" -- which is anathema to the IRS. As a result, much controversy existed in the 1950-1971 period.

In 1970, the President's Task Force on Business Taxation addressed itself among other issues to areas of controversy such as this one and strongly recommended new initiatives in regulations to reduce the resulting uncertainties in business taxation. The completed contract regulations were one of these initiatives. They followed perhaps the most intensive debate and analysis between the Treasury Department and the Internal Revenue Service of any of the regulation projects at that time. Among other objectives, they were deliberately designed to offer a reasonable alternative to the aerospace industry to resolve its unique tax accounting problems, while still protecting the interests of the Government by requiring capitalization and deferral of the deduction of costs until completion of the contract, thus denying the deduction "up-front" of substantial but perhaps unrealistic losses. These cost deferral rules were examined and refined once again in 1982. Senator Roth's proposal would reactivate the controversies by denying the use of the completed contract method of accounting for Defense Department long term contracts. Neither taxing the amounts received nor income on the percentage of completion method resolves the problems.

The Roth bill, in seeking to include in gross income, amounts received under defense contracts, seems designed to treat progress payments on defense contracts as income, even though these amounts represent only interest-free loans to the contractor and traditionally have not been treated as income. See Reg. §1.451-5; Marine Midland Bank v. United States, 687 F.2d 395 (Ct. Cl. 1982). These progress payments are not appropriately a part of income until products or services have ben delivered and income has been realized. As pointed out above this procedure will produce losses during the early phases of a contracts duration.

By using the percentage of completion method with respect to defense contracts, Senator Roth would emphasize an accounting method, which while appropriate for financial accounting purposes, involves an unacceptable degree of uncertainty and judgment on a year-by-year basis for tax purposes. While the existing regulations, Reg. §1.451-5, provide for use of the percentage of completion method, it is not in fact used to any significant extent by defense contractors. The regulations reflect the uncertainty in use of the method. See Reg. §1.451-3(c)(2). Financial accounting may rely upon estimates because year-to-year determinations are not absolutely critical; adjustments may be readily made in financial statements in subsequent years.

The staff of the Joint Committee on Taxation has recognized the importance of certainty in a pamphlet provided for the Committee's use in considering accounting issue tax reform proposals:

> The primary goal of any tax accounting method is to provide a system for assigning items of income and expense to a taxable year so that the net income of the enterprise for that period is clearly reflected. However, there are several concerns involved in achieving a clear reflection of income, not all of which can be completely satisfied by any one method of accounting.
>
> One of these concerns is certainty -- the concept that before an amount is recorded as income or expense, it should be supported by objective, verifiable evidence, and not merely represent a subjective "best guess" of what might happen in a later period. The concern for certainty is reflected in the principle that gain or loss due to a change in asset value should not be recognized for Federal income tax purposes until some transaction confirming that change in value is completed, i.e., until the gain or loss is realized.

Staff of the Joint Committee on Taxation, 99th Cong., 1st Sess., Tax Reform Proposals: Accounting Issues 6 (Jt. Comm. Print, Sept. 13, 1985).

The uncertainty of the percentage of completion method is well documented in defense contracting. In testimony before the Committee on Banking, Finance and Urban Affairs with regard to the Renegotiation Reform Act of 1977, Admiral Hyman G. Rickover criticized the percentage of completion method by stating

> A contractor can vary his profit figures simply by changing management estimates of progress, cost of completion, and contract

> revenues. Since annual profit figures are only estimates, contractors can shift profits from one year to the next, from a good year to a bad; or they can offset an excessive profit on one contract by projecting lower profit or even losses on other uncompleted contracts. In this way, a contractor may avoid excessive profit determinations altogether.

H. Rep. No. 270, 95th Cong., 1st Sess. 12 (May 9, 1977). The Committee also recognized the view of the General Accounting Office that "the percentage of completion method of accounting does not provide assurance of consistency in estimating the percentage of completion . . ." and that "the required use of the completed contract method of accounting in most instances would add necessary objectivity . . ." id. at 13.

Tax accounting requires certainty to the maximum extent possible with respect to income determined on an annual accounting basis. Reg. §1.451-3(d), as it will be amended by the TEFRA regulations, provides that certainty under the completed contract method of accounting.

* * * *

The completed contract method of accounting should be retained for defense contractors as historically developed and refined by the Tax Equity and Fiscal Responsibility Act of 1982. Congress should not modify it at this time because the problems in its application have been fully resolved by the changes made by TEFRA and the comprehensive new Treasury Regulations that have been developed thereunder.

AEROSPACE INDUSTRIES ASSOCIATION

John S. Nolan

John S. Nolan
Counsel

The CHAIRMAN. Mr. Blackburn, are there any abuses of the cash accounting method?

Mr. BLACKBURN. You say any abuses, Senator? On the cash side, if you were going to abuse the cash method of accounting in terms of expenditures, formerly there were abuses in the tax shelter area of paying large expenditures in advance of performance of services. Of course, now the economic performance requirement has been inserted within the code to eliminate that perceived abuse—or that actual abuse—of the cash method on the expense side that was being used in tax shelters. That provision was inserted in the law last year and has not really been given an opportunity to work.

The CHAIRMAN. Now, prior to that, were there abuses in the cash accounting method?

Mr. BLACKBURN. There were abuses on the expense side. Yes, sir, in the tax shelter area on that one issue. Yes, sir, there were, in the context of, let's say, professionals today, I believe that some people may understand that professionals, let's say, defer receipts so that under the cash method they defer income. And that is not the situation with any professional with which I am aware. Certainly, not with the larger firms which, as has been stated, divide their annual profits—their partners' profits—on the cash basis. So, if you are a partner, you want all that cash to come on in. You want to receive it and get your share before other partners come in because, if you don't collect it now and your partnership interest changes the following year, you have lost the money literally because your partnership draw is determined on the cash basis.

The CHAIRMAN. With the changes in the law last year, can you envision any abuses prospectively in the cash accounting method?

Mr. BLACKBURN. No, sir, I cannot.

The CHAIRMAN. None at all?

Mr. BLACKBURN. No.

The CHAIRMAN. Mr. Calkins, you are a good tax lawyer. Could you devise some abuses?

Mr. CALKINS. Oh, I would guess that I could devise some abuses, simply relying on the general proposition that experience seems to show that an abuse can be conceived of in almost any area of the tax law. But I would like to assure the Senator that essentially, for the reason that Professor Blackburn mentioned, abuses which might be conceived of in somebody's imagination don't occur in practice in the administration of service firms, and the reason is that the participants in the firms are dependent upon the cash which is collected to pay their baker and their butcher. And there is, therefore, an inherent discipline which prevents opportunities for abuse from being utilized.

The CHAIRMAN. Now, what happens, Mr. Calkins, and you are well familiar with this, when Congress passes a law and some people find a way to abuse it? And it is a way that we didn't even think of when we passed the law? So, then we attempt to cure it, and often the very practitioners in the field who are not abusing it are of almost no help to us in trying to devise a way to stop the abuse. So, we lash out, with all good intentions, in trying to stop it, and we catch a lot more fish in the net than we ever meant to. It is a frustrating process for us. There were absolutely grievous abuses in the cash accounting method prior to last year in terms of the mismatching of income, and it was easy to do. And yet, even then, we didn't have much help in attempting to draw that law last year. Now, maybe we have cured all the abuses, and maybe not. We have only had it in effect for the year, and we can't tell yet; but on occasion, we could do a lot better at drafting laws if the very groups we are about to affect would say, "Yes, there have been some abuses, and this is how we would suggest correcting them."

Mr. BLACKBURN. Senator, if I could make one comment on the abuses that may occur. As I suggested, if it is not broken, don't fix it. I don't perceive that the cash method generally is broken at this point. If you impose the accrual method of accounting, for most service industries you will run into tremendous problems on satisfying the all events test. I mentioned changing of billing. You will start seeing cash businesses defer their billing until they are certain of collection. Then, you will get into questions about, well, if they are going to do that, then we are going to start taxing work in process. So, you go back and you revise the law to start trying to tax work in process; you get a tremendous system in complexity started in trying to administer the accrual method. So, I perceive more future abuse under the accrual method than under the cash method as it exists.

The CHAIRMAN. Senator Matsunaga.

Senator MATSUNAGA. Thank you, Mr. Chairman. Mr. Blackburn, the Treasury Department asserts that the cash method of accounting produces a mismatching of income and deductions where the taxpayer engages in transactions with parties that employ a different method of accounting. Now, how would you respond to this assessment?

Mr. BLACKBURN. Senator, there obviously, even under the accrual method as it applies for tax purposes, is mismatching. It is a difficult concept. I would say that one of the overriding—one of the most important—principles in accounting to assure—is to ensure consistency over a substantial period of time. Even if there is some slight mismatching in a particular case, if a system of accounting is consistently applied, then that will even itself out over any significant period of time. The cash method of accounting has been in existence, as I said, since the inception of the Internal Revenue Code. There is not a great disparity between taxes associated with, let's say, untaxed receivables even today. If you take the revenues projected, for example, out of this proposal solely from conversion, the existing receivables that are at a very high level, as a matter of fact—so, I think you are looking at a very high level. If there has been any distortion, that is the sole distortion that has occurred over almost an 80-year period. I think there is no substantial distortion or mismatching if you do apply it on a consistent basis.

Senator MATSUNAGA. Mr. Calkins, do you agree?

Mr. CALKINS. I agree with Professor Blackburn's answer, and I would add that the distortion that is involved is only the result of the year-end difference between a client on the accrual method—if your client is on the accrual method, and of course, many are on the cash method also. So, this proposal would produce a reverse distortion the other way with respect to cash basis clients who may have a deduction for their legal fees. And the Internal Revenue Service has not been very much concerned with the kinds of distortion that only affect the year-end adjustment. Tucked away in the accounting provisions there is quite a lot of latitude given with respect to the timing of deductions for supplies and other matters, where the use of the property will occur within a year. The general approach of the Treasury and of the Internal Revenue Service has been to say that, if the only kind of distortion we are talking about is the distortion that is inherent in buying toilet paper in November and using it for 6 months, that isn't the distortion we are going to worry about. And that is the kind of distortion that is applicable in this case, and I would say it simply isn't worth worrying about.

Senator MATSUNAGA. Do you agree, Mr. Carter?

Mr. CARTER. Yes, I do. I think that there are a lot of small construction companies that do not have the sophisticated accounting staff to use either the accrual method or the percentage of completion or completed contract method. It is strictly on a cash basis. And there is just not that much distortion. They are going to perform those services, and they are going to render a bill; and they are going to get paid. There may be a month, 6 weeks, 2 months distortion or mismatching of revenues and expense, but it is not significant.

Senator MATSUNAGA. I recently spoke before a conference of the Western Regional Sheet Metal and Plumbing Contractors Association. Senator Hatfield, Senator Inouye and I formed a panel there, and we were told that, if the President's Treasury II is adopted as is, that they would be paying as much as 37 percent more taxes. Now, these are the smaller contractors, as I understand. Do you agree with that assessment?

Mr. CARTER. I think there could be a substantial increase in taxes in the first year of implementation; but because of the effects of the completed contract method of accounting, in that you have a rollover of contracts, I think that they will eventually pay the same amount of tax. There will be no more revenue generated for Treasury out of this proposal, and in fact, it will put a lot of small companies out of business, and revenues will tend to go down because employment will be reduced and businesses will go out of operation. And the revenues generated by those businesses would just not be paying taxes.

Senator MATSUNAGA. My time is up, Mr. Chairman, but may I just ask this? Just yes or no to the first question that I put to Mr. Nolan: Do you agree with the rest of the panel?

Mr. NOLAN. Absolutely, I do. I practice in a law firm that would be affected by this proposal. The pressure in our firm is to get the money in the door and not to be required to put additional capital into the law practice. We are rendering services. We are not essentially different from employees. If you do not collect the money, you must put more capital in the business, and we do not want to do that. We want to collect the money. So, we are not playing games; the Treasury does not suggest that there is any tax avoidance problem.

Senator MATSUNAGA. Thank you very much.

The CHAIRMAN. Senator Symms.

Senator SYMMS. Thank you, Mr. Chairman. Right in line with Senator Matsunaga's question, Mr. Carter, what you said was that, after the first year or two, it will even out. So, what you are really saying is that Treasury is just trying to reach out there and gather all this money in for the Government in advance. Somehow, somebody down here who counts numbers thinks that they are going to be able to catch up and get ahead on the payments. Is that basically what you are saying?

Mr. CARTER. Yes, sir, essentially that is correct. I think that they perceive that there is out here somewhere an ever-increasing volume of deferred taxes, and that somehow construction companies and other companies are avoiding ever, ever, ever paying taxes, and that is just not true.

Senator SYMMS. My interpretation of that is, coming here as a small businessman to this committee, that cash accounting causes better planning, or its indirect effect of it on the part of the small businessman because, if he invests in next year's expenses with some of the cash that he might bring in at the end of his accounting year, and then reinvest it in next year's expenses—if it is a construction company if he buys fuel and spare parts or whatever—then he is that much stronger, that company is, for going into the next year in case of bad times. Particularly, this is true in agriculture. I want to ask you a question about these progressive payments. Treasury tries to tell you that the progressive payments are you are doing a job and you are getting paid—that that is income. Correct?

Mr. CARTER. That is correct.

Senator SYMMS. How often does a small contractor get out here on a job where he slightly underbidded, and there isn't any profit in the job?

Mr. CARTER. That frequently happens. If estimating a contract was a science instead of an art, every contractor would make a profit on every job; and every contractor would be the low bidder because they would all be able to identify their costs precisely; and they would all make a profit, and they would all be paying taxes. But that never happens. Risks change every day, and contracts that start out profitably will lose money. And those projects will get progress payments. Almost every construction contract will provide for progress payments, but those progress payments are to reimburse the contractor for the cost of labor, materials, subcontracts. And they are no more income to that contractor than deposits in a bank.

Senator SYMMS. Profits, you mean?

Mr. CARTER. They are not profits. That is correct.

Senator SYMMS. They are just meeting expenses with those?

Mr. CARTER. That is correct, and every one of those progress payments carries with it the responsibility of completing the contract. They are supposedly for reimbursement of costs incurred for work put in place, performance to that point in time; but if at any point in the future, it is determined that the work put in place is either incorrect or incomplete or unsatisfactory, the contractor has the responsibility to repair, replace, complete, whatever, with no additional payment. And that could very well change his contract from profitable to loss. And I have seen contracts change from profit to loss in the last month of the contract.

Senator SYMMS. I think that is a very good point that is often missed by the IRS side of the question and by the Treasury side of the question, that they don't realize the risks that you have to take to bid on a job; and the whole contract accounting system in progressive payments is just a way of doing business. Mr. Calkins, you know this same rule that affects law firms affects agriculture units. If it is a $5 million agriculture operation, it is supposed to go to an accrual accounting system. If it is less than $5 million, they can still remain on a cash accounting system, unless they use an accrual accounting system in establishing credit. Now, can you tell me any business that you know of that doesn't go into the bank when they borrow money and list on their accounts receivable as an asset in their company, and say that this is money that is coming in and list it as an asset?

Mr. CALKINS. I am not familiar with any business that borrows money without disclosing their accounts receivables, and I would doubt there is any bank that ever loans money——

Senator SYMMS. Let's say that you were in a law firm that did $2 million worth of business, instead of over $5 million; so you were planning on staying on an accrual accounting system, and you had a big accounts receivable coming in. Then, you go to the bank and use that to establish some credit for some other thing—to buy a building to put the law firm in, for example. Don't you think that then the IRS agent could come in and say you used this method; so, we are going to make you go to an accrual accounting method?

Mr. CALKINS. We would take extraordinary precautions so that we would make it clear to the bank that we were giving him cash basis figures and only collaterally telling him about the receivable that you are referring to. So, I think we could protect ourselves, but there would be a number of people who would not do it as carefully as they should.

Senator SYMMS. In agriculture, I can't think of any farmer that I know of who doesn't go to the bank to borrow money and he lists all of his assets. You know, he has 50 head of cattle that are going to be sold; and so, he is using an accrual accounting system to establish credit to borrow money, and yet he is on a cash accounting method. I mean, there have been a lot of ideas come out—and I see my time is up—but I think, Mr. Calkins, the whole motivation for this is just the pressure on the Treasury people because of the big deficit. If Congress would quit spending so damned much money, we wouldn't have all this pressure and these guys wouldn't come up with these kinds of ideas because I think people do better business on a cash system. I know farmers do. Otherwise, if they have money in the bank, there is no incentive to invest in next year's fertilizer; then they go off and spend it on some investment. And then next year, they are into the FMA or somewhere broke.

Mr. CALKINS. In August, I testified before the Ways and Means Committee in my individual capacity and was critical of most of the accounting provisions in the President's proposal because I think they are attempting to do just what you say. As Mr. Carter has said, if you need to pick up money to develop revenue neutrality, one of the first places you look is for places to accelerate income or defer deduction because the short-term effect of accelerating the income and deferring the deductions is to have a significant effect on the way the figures appear. The Treasury proposal only gave us figures for, I guess, it was 1985 or 1986 through 1990 and didn't show us what happened after 1990. The pickup that these accounting changes appear to produce and which are reflected in the figures for the end of this decade will simply not be reproduced in the 1990's.

Senator SYMMS. I thank you very much, Mr. Chairman, and I apologize for going over my time.

The CHAIRMAN. That is quite all right.

Senator SYMMS. I want to thank all the witnesses also.

The CHAIRMAN. I have no more questions. This was a very good panel. I had a chance to read your testimony ahead of time. It was first rate. Thank you. We are adjourned.

[Whereupon, at 11:48 a.m., the hearing was adjourned.]

[By direction of the chairman the following communications were made a part of the hearing record:]

ACEC File #700.10
726.01

American Consulting Engineers Council
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202-347-7474
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October 8, 1985

The Honorable Bob Packwood
Chairman, Committee on Finance
United States Senate
219 Dirksen Senate Office Building
Washington, D.C. 20515

Dear Mr. Chairman:

We are pleased to submit our comments on the proposed tax reform legislation for the Finance Committee's consideration. We request they be included in the hearing record.

The American Consulting Engineers Council (ACEC) is a professional association of some 4,300 member firms with nearly 120,000 employees providing consulting engineering and related professional design services to public and private sector clients across the nation and around the world.

We support an overall tax reform package which reduces complexity, encourages investment and promotes growth in the American economy.

Many of the proposed changes impact our principals, their firms and the consulting engineering market. One particular proposal, however, stands out as destructive to professional firms while producing little additional revenue. Under the President's plan more than 60% of our member firms would no longer be permitted to use the cash method of accounting to report taxes. The exceptions are limited to those who have used only this method and whose annual gross receipts are $5 million or less (Chapter 8.03 of the President's tax reform proposal). Consulting engineers, like most professional service firms, carry a substantial balance of accounts receivable. Under the proposal they would be required to use accrual accounting for tax purposes, to report and pay taxes on income when it is earned, not when cash is finally received.

In a recently completed study by the Design Coalition for Tax Accounting, 83% of the respondents expected an increase in tax liability, 62% expected a substantial increase, and over 50% would have to combine borrowed funds with working capital and increased fees to meet the added tax demands. This would reduce the liquidity of design firms, lower profits by the amount of the interest costs and reduce future profits on which the firms would be taxed. This is clearly an ill-conceived and unfair proposal with significant negative economic impact on the firms and the entire services sector of the economy. ACEC urges serious reconsideration and deletion of this proposal.

We have also included comments on 3 other tax proposals which have a varying impact on the A/E community. Most of the proposed changes either positively or negatively impact the market for A/E services rather than design professionals themselves. The attached are proposals which we feel will impact the most on the A/E industry.

In a related matter, we suggest for the Committee's consideration a proposal to allow consulting engineers to set up tax-exempt trust funds for the purpose of self-insurance. This was originally considered by the Finance Committee in 1981 as S 1081 (HR 248). Engineers and architects, as design professionals have learned by experience what the high cost of design liability means. In an environment in which claims against A/E firms are ever increasing, liability insurance is an increasingly expensive even unavailable protection, particularly in a vital field such as environmental hazardous waste clean up. Today only two insurance companies offer policies to new clients and all are excluding high risk activities such as hazardous waste and asbestos removal. An increasing number of A/E firms are practicing without liability insurance because it is unavailable.

ACEC strongly supports reintroduction and passage of this legislation which will provide relief in the area of liability insurance for design professionals. Because the legislation makes it possible for design professionals to, in effect, insure themselves for part of their liability losses, making it possible for some to obtain insurance for the rest, we believe this legislation is a fair and balanced solution, vital to the protection of the public health and safety. Currently all insurance premiums are tax deductible expenses. We believe retained earnings for self insurance should be treated the same way.

We appreciate consideration of these matters and look forward to working with you in the passage of tax reform legislation.

Sincerely,

Arnold L. Windman
President

Associated
Builders and
Contractors, Inc.

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STATEMENT OF
ASSOCIATED BUILDERS AND CONTRACTORS, INC.
PRESENTED TO THE
COMMITTEE ON FINANCE
OF THE
UNITED STATE SENATE
REGARDING
THE COMPLETED CONTRACT METHOD OF ACCOUNTING

Hearing on Long-Term
Accounting Issues
October 4, 1985

Submitted October 18, 1985

Mr. Chairman and Members of the Committee on Finance:

ASSOCIATED BUILDERS AND CONTRACTORS appreciates the opportunity to present its position on the completed contract method of accounting as one of the long-term accounting issues examined by the Committee during its October 4, 1985, hearing.

ABC believes that the completed contract method is essential to the economic strength of America's construction industry. Further, the industry's conscientious use of this accounting method since 1918 justifies its preservation in our nation's business tax code.

To prepare this statement, ABC staff has drawn on the expertise and experience of the Association's growing membership: 18,000 contractors, subcontractors, and related firms involved in open shop construction, which is used in 70 percent of all building projects in the United States today. The Association was founded on the "merit shop" philosophy, a concept which calls for open, competitive bidding that leads to the awarding of a contract to the lowest responsible bidder.

To establish an accurate perspective of construction's major role in our economy, the National Construction Industry Council states that this industry alone contributes as much to the Gross National Product as the steel, automobile, textile, aerospace and paper industries combined. Department of Commerce figures for 1982, the most recent year for which data are available, place the construction industry's contribution at $314 billion. The number of companies, exclusive of bonding, insurance, design and engineering firms, totalled approximately 442,000. These companies, in turn, provided jobs to more than 4.3 million workers for a total payroll in excess of $78.5 billion.

The magnitude of these data underscores an indisputable point: Any proposed tax changes affecting construction will have far-reaching, and possibly unforeseen, consequences that could be felt well beyond the industry itself.

Although ABC's member companies are diverse in size, location, activity and capability, they all share one common characteristic. They are highly labor-intensive operations that depend heavily on capital-intensive industries. The owners and managers of these companies are highly sensitive to the issue of tax reform and its potential economic effects.

On a more practical level, the Association's members are business people who face daily frustration with the complexities and inequities of our current tax system. They realize that a major overhaul is the only solution to these problems, but they also believe that any reform must be fair to America's construction industry if it is to be fair to the nation and to justify the wide-ranging effects it will certainly have.

Accordingly, Associated Builders and Contractors neither supports nor opposes any tax reform package as a whole. Our members believe that specific provisions of any proposal should receive the careful and deliberate consideration of this Committee. The Association is solidly opposed to any portion of any tax reform plan that unfairly burdens the construction industry. Proposals to replace or eliminate the completed contract method of accounting clearly harm this major industry, and ABC believes they are both unwarranted and unfair.

The completed contract method of accounting is a method of reporting income (gain or loss) for tax purposes from long-term contracts. The method dates to 1918, when the Department of the Treasury included the provision in regulations issued two years after enactment of the business tax. Then, as now, it was developed to be the most fitting and accurate accounting method for contractors. Allowing manufacturing operations to use this accounting method was not the intent of the Treasury's original regulations.

The requirement of the completed contract method is straightforward and easily understood. It simply requires a construction company to wait until a contract is completed and accepted by the owner before the company can report a gain or loss for income tax purposes. By making this requirement, the method meets the "all events" test, which holds that a taxpayer must perform all responsibilities necessary to earn income (or realize a loss) before a gain or loss can be declared. A construction contractor has no positive claim to a gain or loss from a contract until the project is finished and accepted by the owner, and the use of the completed contract method in the industry correctly reflects this fact.

In the 1960s, companies performing contracts vastly dissimilar to those of contractors tried to qualify for the completed contract method by means of judicial interpretation. Until this effort succeeded in 1976, use of the method was limited to construction, building and installation contracts — those traditionally used in the industry when a company builds a single unit.

In 1976, the Department of the Treasury changed the eligibility and use rules concerning the completed contract method and added a new category of long-term manufacturing contracts to the eligibility list. Companies very different from construction firms — shipbuilders and manufacturers of weapons, heavy equipment and aerospace products — were allowed to use the method for their production contracts.

At roughly the same time the eligibility and use regulations were changed, the Internal Revenue Service issued revised regulations with detailed rules for companies electing to use the completed contract method. Today, these rules remain in use in the construction industry and are considered fair standards.

The changes made by the Treasury Department in 1976 sowed the seeds for abuses of the method which came to light several years later in cases involving manufacturers' improper administration of the method. In some cases, contract completion dates were delayed by adding contractual "duties" that were not originally related to the initial contract, such as the production of spare parts or the development of technical manuals. In other cases, completion of manufacturing contracts — and their tax consequences — was postponed by "stretching out" production runs with incremental increases in the number of units to be produced. Because of financial and contractual practices in the construction industry, contractors do not use — and have no monetary incentives to use — these delaying tactics.

With these abuses in mind, the Treasury Department in 1982 proposed that the completed contract method be replaced by the progress payments method. In congressional hearings that preceded the enactment of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), construction industry organizations identified the defects in the Treasury's proposal, and the department subsequently discarded this concept.

In a notable statement of position, the Reagan administration in 1982 noted the importance of the completed contract method to the construction industry. Donald T. Regan, the current Secretary of the Treasury, wrote to Senator Robert F. Dole, who chaired the TEFRA Conference Committee: "After further consideration, I am concerned that the Senate provision dealing with the completed contract method of accounting is perceived to have an unnecessarily adverse impact upon the construction industry at this time."

When it finalized TEFRA, Congress recognized the differences between construction and manufacturing users of the completed contract method. The cost-allocation rules under the Act for long-term contracts were not made applicable to construction contracts of under 36 months in duration or to contractors with less than $25 million in annual gross receipts. TEFRA's revised cost-accounting rules for extended long-term contracts were, however, applied to all manufacturing contracts longer than 24 months, regardless of the manufacturer's size.

In the current debate on tax reform, Congress has been presented again with proposals to replace the completed contract method. ASSOCIATED BUILDERS AND CONTRACTORS remains firm in its belief that the unique characteristics of the construction industry and the proven suitability of the completed contract method for determining the tax liabilities of contractors justify its retention in the business tax system.

Chapter 8.01, "Revise Rules for Production Costs," of President Reagan's "Tax Proposals for Fairness, Growth and Simplicity" recommends a single set of capitalized costs for manufacturer inventories, taxpayers with long-term contracts, as well as farming and timber.

This idea effectively eliminates the two key exemptions allowed construction — contractor size ($25 million in annual gross receipts) and contract duration (less than 36 months) — which were included in the tax code by TEFRA in 1982. In addition, this proposal would define interest as a capital cost.

The tax reform proposal now under consideration by the Committee on Ways and Means of the House of Representatives would repeal the completed contract method. Income from long-term contracts would be reported using the percentage of completion method. Interest would be paid by, or to, the taxpayer if the actual profit on the contract varied from the estimated profit used in reporting income.

Neither of these proposals accounts for the unique operational and financial factors which contractors face, and neither gives an accurate and fair assessment of the tax liabilities of these companies. In addition, these proposals have been advanced despite the fact that the construction industry has been consistently conscientious and responsible in its use of the completed contract method.

The completed contract method, in contrast, recognizes the financial effects of the inherent risks and practices that mark the construction industry. When a contractor wins a contract and begins the project, the company is presented with a set of physical circumstances beyond its control, all of which affect its performance and its final profit. These include: site location, climate, soil conditions, and materials manufactured specifically for the project.

Modern construction projects require a diversified labor force that may involve as many as 50 specialized subcontractors and related firms that employ a wide range of support, crafts and professional workers. The different wage rates for these employees significantly add to the difficulty of determining the final labor costs, and thus the final profit, of a project.

From the outset a contractor expends large sums to get a project underway before it has any contractual right to collect from the owner. Unlike major manufacturing industries, construction companies typically do not have sizeable capital resources. Thus, a contractor's financing capability is often stretched to its limit. During the project, building plans may change, modifications may become necessary, and claims may arise. Each situation may require a contractor to draw on its capital before it collects from the project owner.

Perhaps the most important financial consideration which the completed contract method takes into account is the practice of retainage. Incorporated into virtually all construction contracts, this provision allows an owner to withhold (retain) part of the payment (usually 10 percent) until the contract is completed. Retainage typically is used for corrections and defects after project completion and may be withheld from the contractor's progress payments or from the total contract price. General contractors usually withhold retainage from subcontractors for this purpose.

The 10-percent retainage often equals or exceeds a contractor's combined overhead and profit, which are traditionally low because of intense competition in the construction industry. As a result, a contractor often does not receive its profit until the owner releases the retainage at the completion and acceptance of the project.

Retainage affects all contractors on a project. A general contractor cannot pay retainage to its subcontractors until it first receives retainage payments from the owner. This linkage has a long-term effect on companies such as excavators and concrete contractors, which are involved in the opening phases of a project. These firms must wait the longest to receive their retainage payments from the general contractor -- perhaps as long as two years.

Proposals to eliminate the completed contract method and require a contractor to pay taxes on funds received as progress payments during the course of a project ignore a second key financial practice. Beyond the fact that progress payments do not contain a profit element for a contractor, neither do they relate directly to the cost of the work performed at a particular stage of a project. In many cases, contractors receive mobilization payments or contract advances at the outset of a project in recognition of the high capital outlays required for start-up. Although these payments may help offset large outlays early in a project, the initial expenditures nonetheless place a financial strain on a contractor. Taxing such advances and mobilization payments would be akin to taxing working capital loans.

No other tax provision or proposal other than the completed contract method accurately accounts for the risks, retainage withholdings, and advance payments which are part of doing business for companies in the construction industry. No other provision or proposal can so accurately determine a contractor's tax liability, because only the completed contract method requires a company to wait until its work is completed and accepted.

Contrasting the operating environment of a contractor with that of a manufacturing firm further demonstrates the special suitability of the completed contract method to construction.

Unlike a contractor which typically receives its profit long after its work is finished, a manufacturer converts its inventory through sales into receivables in a relatively short time. Receivables contain a manufacturer's profit and may be collected in 10 to 90 days, which means a manufacturer's cycle of expenditures to realizing a profit is considerably shorter than that of a contractor.

Unlike construction, manufacturing operations typically take place in strictly controlled environments that have been structured for predictability, optimum production rates, and low costs. Manufacturing environments do not present the same variables, risks and unforeseen costs a contractor faces on a job site. Further, manufacturers can increase efficiency and reduce costs over the course of a long production run of identical units. These advantages cannot be achieved by contractors when they build unique units under conditions that are never the same.

Regarding the use of the completed contract method, the construction industry has established a record of responsible use since the method was initiated in 1918.

Contractors through the years have recognized that the completed contract method was developed for use specifically by construction, and they have worked to be justified in their use of this provision. Today more than ever, construction companies recognize the need for the completed contract method.

Operationally, contractors do not produce spare parts or technical manuals, or obtain "add ons" to postpone the completion date of a contract and the accompanying tax consequences.

The financial capabilities of construction companies, and the competition they face, discourage this practice. No financial gain accrues to the contractor that stretches out a job -- efficiency makes money. Earning a profit in the construction industry depends on a company's ability to use its employee and business resources to complete a job on time and within budget.

The effects of repealing the completed contract method of accounting will be immediate and severe.

Contractors will be forced to borrow money to pay taxes on work in progress, which will strain cash flow and capital resources as never before. Companies' expenses will climb due to their requirements for more accounting and bookkeeping personnel as well as more paperwork.

Bankruptcies and turnovers will become more frequent throughout the industry, as will contractual defaults. These business failures and delays will bring with them the attendant economic and social costs of unemployment, which will strike hardest at younger, lower-skilled workers who may not be suited for employment in other industries. These trends certainly will extend beyond contractors themselves to suppliers and other construction-related firms.

Many more companies will be required to raise their bid prices and reduce their scope and level of business in order to compensate for lower earnings and higher operating costs.

Since 1918, the completed contract method of accounting has stood as the most accurate and equitable procedure for reporting income from long-term construction contracts because its authors understood the industry's unique risks and specific operating practices. Today, some seek to correct unintended uses of the method by eliminating it for all, even those companies for which it originally was intended, rather than by developing solutions that address specific irregularities with the method's use.

The completed contract method of accounting has accumulated almost 60 years of experience in the construction industry and has made possible projects of all types that would not have been built otherwise. In 1982, Congress recognized the significance of this time-tested method to America's contractors by including in the tax code specific provisions for its use by this industry.

ASSOCIATED BUILDERS AND CONTRACTORS urges the members of the Finance Committee to reaffirm the important role that construction plays in our nation's economy and reject any proposal to alter the industry's use of the completed contract method of accounting.

August 1, 1985

STATEMENT OF
ASSOCIATION OF AMERICAN PUBLISHERS, INC.
IN OPPOSITION TO
THE PRESIDENT'S PROPOSAL TO REPEAL SPECIAL ACCOUNTING RULES FOR MAGAZINES, PAPERBACKS, AND RECORDS RETURNED AFTER THE CLOSE OF THE TAXABLE YEAR
TO
COMMITTEE ON FINANCE
UNITED STATES SENATE

The Association of American Publishers, Inc. ("AAP"), a not-for-profit trade association, represents publishers of 80 to 85 percent of the general books, textbooks and educational materials, including films, audio tapes and records, produced in the United States.

The Association of American Publishers applauds the efforts of this Committee and the Administration to enact a comprehensive tax reform package that achieves both fairness and simplicity by eliminating tax preferences and subsidies for special interest groups. However, the AAP objects strongly to the Administration's proposal to repeal Internal Revenue Code section 458, enacted in 1978 to provide a method of tax accounting that clearly reflects the income of publishers of books, magazines and records.

Section 458 allows a publisher to exclude from income amounts attributable to sales of overstocked publications that are returned to the publisher for full refund or credit shortly after the close of the taxable year. The repeal of section 458 is inequitable and inappropriate for the following reasons:

-- Section 458 was enacted to establish a method of accounting that would clearly reflect income in view of a common business practice of the publishers of mass-marketed products, and so is necessary to the proper functioning of the tax law. Section 458 is not a special subsidy or tax preference for the publishing industry, but rather operates merely to extend to publishers the equitable accounting treatment provided to other taxpayers.

-- Repeal of section 458 would not have a meaningful revenue impact upon the Federal treasury, but would impose a substantial economic burden upon a small sector of the business community.

I. SECTION 458 WAS NOT ENACTED AS A TAX SUBSIDY FOR THE PUBLISHING INDUSTRY; RATHER, IT WAS DESIGNED AS AN EQUITABLE ACCOUNTING METHOD CLEARLY REFLECTING THE INCOME OF PUBLISHERS.

Section 458 is a statutory clarification of the application of the accrual method of accounting to a common mass-marketing promotional practice utilized by publishers and distributors of magazines, books, and records. This promotional practice, generally referred to as "overstocking," is the sale by a publisher to a retailer of a significantly greater number of copies of publications than the retailer anticipates will be sold to ultimate consumers. Overstocking allows retailers to satisfy peak demands of consumers, and, more importantly, to display particular products conspicuously.

Publishers of magazines, books and records rely heavily upon conspicuous display of their merchandise at the retail level to promote sales in the mass market. Copies of publications that "overstock" a retail outlet are a major form of advertisement for the products. Retailers are willing to promote publishers' merchandise by overstocking because publishers allow retailers to return unsold products for full credit or refund.

Publishers know from experience that a significant number of publications "sold" to retailers during a taxable year will be returned for credit or refund soon after the year's close. For example, the American Institute of Certified Public Accountants has estimated that 60% of all paperback books and 65% of all magazines shipped are later returned to the publishers.

Although the publications returned by retailers soon after the close of the year typically were shipped to those retailers primarily for display -- *i.e.*, advertising -- purposes, the Internal Revenue Service took the position prior to 1978 that publishers must include in income all sales of publications shipped to retailers during the year, but could deduct returns of merchandise only in the year received. Because a return of merchandise may not occur in the same taxable year in which the corresponding sale is recorded, the method of accounting mandated by the Internal Revenue Service prior to 1978 consistently and significantly overstated publishers' incomes.

Congress responded to the inequity resulting from the Internal Revenue Service's position by enacting section 458 of current law. Revenue Act of 1978, P.L. 95-600, 95th Cong., 2d Sess. § 372. Section 458 permits publishers to elect to exclude from income amounts attributable to the sale of publications that are returned within a specified period after the close of the taxable year. Because the exclusion applies only to returns actually made, there is no possibility that the provision will operate to decrease a publisher's taxable income artificially.

The legislative history of section 458 makes it clear that the provision was enacted not as a special subsidy to the publishing industry, but rather to clarify and implement the proper accounting method for the practice of overstocking. When the provision was first introduced in the House of Representatives, Congressman Ullman explained its purpose as follows:

> The Internal Revenue Service has taken the position that accrual-basis publishers and distributors must include in income the sales of magazines, paperbacks, or records shipped during the taxable year, and may deduct returns in the year they are received. Because the return may occur in a later year, the present accounting method does not accurately reflect income subject to tax, and is unfair to these publishers and distributors.

124 Cong. Rec. 15,072 (Part 11, May 23, 1978) (statement of Rep. Ullman, emphasis supplied).

Senator Cranston reiterated the need to correct the accounting rules to reflect the income of publishers more accurately when the provision was offered -- with Treasury approval -- as a Senate floor amendment to the Revenue Act of 1978:

> [U]nder existing Federal tax law, taxpayers in the magazine, paperback book, and record industries are required to include all shipments of their products in income, even though it is known that a high percentage of the copies "sold" will, in fact, be returned. When these returns occur after the close of the taxable year, the reduction in income falls in the wrong tax period, resulting in an overstatement of income in the year of shipment....The attached amendment seeks to avoid the overstatement of income without permitting the estimation of a reserve for tax purposes....There is general agreement that this change in accounting method is equitable and will result in a more accurate reflection of income for the industries included in the bill. The amendment is noncontroversial.

124 Cong. Rec. 34,601 (Part 26, October 7, 1978) (statement of Sen. Cranston, emphasis supplied).

Thus, Congress enacted section 458 as a corrective measure to enable taxpayers to use an accounting method that clearly reflects income, as required under existing Code section 446. As the above excerpt demonstrates, the provision was not intended to provide publishers with an accounting method more favorable than that enjoyed by other industries; to the contrary, the provision sought to place publishers on an equal footing with other taxpayers.

The Administration's tax reform proposal would repeal section 458, effective for taxable years beginning on or after January 1, 1986. President's Tax Proposals to the Congress for

Fairness, Growth and Simplicity, Chapter 12.02 at 299 (May 29, 1985). The provision is categorized as a "tax subsid[y] for particular businesses," id. at 295, and repeal is justified under the guise of tax purity.

Contrary to the President's suggeston, however, the legislative history previously quoted above demonstrates clearly that section 458 is not a tax subsidy. While the provision modifies the general rule for the accrual method of accounting, the modification is necessary because, as Congress explicitly noted, the general rule does not function properly to reflect income clearly in this special circumstance.

A repeal of section 458 in the context of a tax reform proposal that seeks to promote fairness is all the more incongruous. The goal of fairness is not furthered by the imposition of an unjustifiable burden upon a small segment of the business community. Tax reform that seeks to measure income with neutrality must not prevent selected taxpayers from using accounting methods that clearly reflect income.

II. THE REPEAL OF SECTION 458 WOULD NOT ADD SIGNIFICANTLY TO FEDERAL REVENUES, BUT WOULD IMPOSE A SUBSTANTIAL ECONOMIC BURDEN ON THE PUBLISHING INDUSTRY.

While the repeal of section 458 cannot be justified as a matter of equity or fairness, neither can it be justified as a important revenue raising measure. The estimated revenue impact of the repeal of section 458 is only $2 million in 1986, and an additional $1 million in 1987. The revenue estimates of the Joint Committee on Taxation for this provision is $1 million annually in 1986, 1987 and 1988. Although these amounts are negligible in the large scheme of comprehensive tax reform, they are significant when extracted from a small segment of the nation's industries. In short, the repeal of section 458 would impose an unjustifiable burden upon the publishing community and detract from the integrity of the tax system, while producing no tangible benefit to the Treasury.

Club Corporation of America

COMMENTS
OF
CLUB CORPORATION OF AMERICA
TO THE
COMMITTEE ON FINANCE
OPPOSING PROPOSED CHANGES IN THE TAX DEDUCTIBILITY OF CLUB DUES AND BUSINESS MEALS

October 1, 1985

Club Corporation of America (CCA) and its subsidiaries have been in the business of developing, owning and operating private clubs since 1957. Today, clubs which are part of the CCA family of clubs number 165. They consist of city clubs, golf clubs and city-athletic clubs. We are the largest private club management company in the United States and employ over 10,000 people, many of whom are minorities.

Impact on Revenue and Employment

I have attached to this statement an analysis of several of our clubs showing the impact of the President's tax reform proposals on our company. Surveys of our clubs were made to estimate the loss of membership as well as the impact of the business ~~meal~~ limitations. The results are staggering. For example, in the case of a 25% drop in membership (dues) 70% of our clubs will experience a decrease in net cash flow leaving them unable to meet existing rent and debt service obligations.

We have evaluated every club in our system and have determined that 97 clubs will have to close their doors and will put 5,900 employees out of work.

Because of the high fixed operating costs of these facilities, even a 10% drop in membership will produce a 45% drop in net cash flow and will force us to close not less than 61 clubs and lay off 3,700 employees.

It is important for this Committee to realize that dues are absolutley critical to a club's existence. Dues provide the dollars needed to cover fixed overhead: fixed payroll cost, insurance, utilities, property taxes, etc. Since variable costs in a club are relatively small, the only practical way to attempt to reduce costs to meet reduced revenues is through large payroll reductions. However, as our analysis has shown, only a small percentage of clubs can withstand these revenue reductions.

Businessmen are the key source of new members in a club especially city clubs. If legitimate dues deductions are disallowed, not only will existing members resign but the source of new members needed to sustain a club will be almost totally eliminated. Under the proposed legislation, businessmen can effectively double their promotion/advertising expenditures in other areas and be as well off dollarwise as being a club member. Clearly, the rational businessman is going to convert his nondeductibile dues dollars to some deductible use - he can't just stop promoting or trying to draw business to his firm. As a result, the direct revenue benefit to the Treasury will be nil: clubs will have to shut their doors and thousands of club industry employees will have to be terminated.

The Purpose of a Private Club

Virtually all of our clubs exist primarily to serve the business and professional segments of their respective communities. The club Board of Governors typically consists of senior executives of major local companies. The physical design of the clubs generally provides for more spacious seating and more private dining room areas than public restaurants for the express purpose of providing a better, less noisy atmosphere for business discussions.

For many business people, CPA's, lawyers, architects, investment counselors, investment bankers, manufacturer's representatives, etc. the use of television, radio, newspaper or billboard advertising simply isn't practical. Selling a sophisticated computer system, a long-term service contract, or your professional skills is a lot different than selling soap on television!

In these situations the personal relationship between the seller and the buyer is critical. As a buyer, my feelings about the seller's integrity, responsiveness to my needs, and his depth of understanding of my problems are critical in making any purchase decision. A club environment and the business lunch provide a setting and an opportunity in which I can evaluate these factors.

Theodore Levitt, professor of marketing at the Harvard Graduate School of Business Administration, has described the important role of the business lunch in his book "The Marketing Mode". He says of this form of sales:

> "It is so important and so central to the industrial selling process that it * * * is taken for granted like oxygen in the air * * * [T]he lunchee does not make his buying decision purely on price, specification, technical services, or delivery. The lunch exists to help create relationships of personal trust and understanding * * * to go beyond the slide rule and the laboratory in getting and cementing sales. * * * Advertising performs much the same function as the business lunch. It creates familiarity. With familiarity is likely to come conviction and trust."

Fairness

We are told these elements of the President's proposal have come about because of a government perception of a public perception of abuse. There has been no disputing by anyone that a substantial amount of club usage and business lunch activity is in the direct pursuit of business interests. The avowed problem is that there is a perception of abuse (ostensibly because there is an opportunity for abuse).

Most businessmen resent the only interpretation possible from these proposals, namely, that most businesspeople are dishonest and that most of their deductions of club dues and business meals is not in pursuit of legitimate business purposes but rather is a personal indulgence. If their interpretation is not correct then these items should remain deductible!

The underlying attitude of the administration appears to be that if a business person has any opportunity to take advantage of the tax system for his personal benefit, he will do so. Fairness requires that all such "opportunities for abuse" be dealt with even-handedly. If it is "fair" to assume that business people abuse their rights in the area of clubs and other business entertainment areas, then it is equally "fair" to assume that they are abusing it in other areas - especially those that may affect the comfort of their surroundings or may appeal to their egos.

The government has admitted that the actual abuse is probably small but because of a "public perception" of abuse, these changes need to be made to restore confidence in our tax system. In short, the administration is saying "we need a sacrificial lamb" to show the people we aren't letting business get away with special privileges. That is not fair. If the government is going to make economic decisions on the basis of some perception of public opinion, go on and really become a hero to "the public" and regulate all of the expense areas of business where waste is present. At least in that way, my company and others in our business won't be so singularly selected for extermination.

If indeed fairness is a central criterion in these tax proposals, then it is obviously unfair to preserve the deductibility of appropriate means of selling bars of soap, but to deny or limit the deductibility of appropriate means of selling more significant products or services where inducing trust and confidence between buyer and seller is essential. This anomaly only serves to emphasize the perverse results obtained when the bureaucrats seek to dictate acceptable and unacceptable marketing channels.

Personally what I am about to suggest is totally contrary to what I think is right for our country, but it is more right than having the government pick and choose among "perceived" (and unproven) abuses. Moreover, it will mean many, many times the additional tax revenue assumed by the current proposals. In short, I would have less problem with the President's proposals if they went far enough - if they would control all other areas in which there is "opportunity for abuse." All business expenses which have the "opportunity for abuse" (because of a perceived element of personal benefit) should be treated in the same manner!

For example, it is a simple fact that businessmen don't need the quality level of desks, chairs and decorations they have; they don't need to have office space in the newest and highest rent buildings; they don't need above average carpets on their floors; they don't need the well appointed boardrooms most of them have. And, why should a business be allowed to deduct expensive television "image" advertising that makes no attempt to sell a product or service, but simply is done to convey the message that "we are a great company"?

If these things aren't needed to function effectively, why do business people choose to spend these dollars? There are two possible explanations. They do it because the extra dollars spent provide some ego satisfaction or other personal benefits. Or, they do so because in their judgement, these expenditures are important in creating the proper environment, image or impression for the effective conduct of their business.

These two possible explanations are exactly the same ones to explain why a businessman spends dollars for club dues or business meals! Very simply there is no basis for treating these expenditures differently. If an expenditure is "excessive" it is an abuse according to the attitude of the tax reform proposals. If so, all similar abuses need to be treated in the same way.

The "fairness" standard of the proposals will not be followed if the government selects only one perceived area of "abuse" over others for disallowance. The government should establish expenditure levels in all areas of business. There is no rationale that can explain why club dues/business meal expenditures are more suspect than desks, carpet, office rent, etc. At least in the dues/business meal case there is some possibility that a sale will be made or a business relationship enhanced. Can anyone realistically argue that a $1,000 desk rather than a $500 desk offers the businessman opportunities to increase his sales?

The thrust of the President's proposals is that all income belongs to the government unless it is specifically remanded to the company or individual that earned it. This thinking prompts critics of clubs and the business lunch to argue that the government is "paying for" part of the lunch, i.e., a government subsidy.

This argument is seriously flawed. If the money spent on club dues and business meals is productive, i.e., if it serves to maximize net income, then no subsidy is involved. Rather, the spending for this purpose will increase net income and increase tax revenues. Thus, from an economic standpoint it makes no more sense to disallow these expenses than it does capital equipment, salaries or advertising - all of which are used to generate profits.

The key question, then, is whether money spent for club dues and business meals helps to maximize profits. Nowhere has the government addressed this issue - probably because it would be impossible to show that the dollars spent are really wasted. It must be remembered that most of the dollars so spent come out of the shareholders' pockets, not the government's. If these expenses really represented a waste of corporate assets, shareholders would not tolerate it.

Certainly, I am not trying to argue that every dollar spent on dues and business meals is put to good use. Undoubtedly there is some waste. But large sums are also wasted on obsolete plants, lavish offices and incompetent employees. Waste can't be avoided and keeping it under control is the job of management, not the government.

At least corporate managers are disciplined by the need to produce profits - shareholders will not endure poor results for long. Can anyone seriously believe that a Washington bureaucrat can make these decisions more effectively than the profit-motivated businessman? Given the enormous waste in government already, this attempt to substitute bureaucratic judgment for free enterprise judgment is even more remarkable. Congress must decide whether the assumed public relations benefit of these proposals is worth the extreme price of moving us even closer to a more socialistic economy where the government makes more and more of our business decisions and choices for us. We can't have our cake and eat it too.

Testimony of Leslie Jay Schneider
of Ivins, Phillips & Barker, Washington, D.C.

on behalf of
The Committee for Reasonable Inventory
Accounting Rules

Before the Senate Finance Committee
October 4, 1985

COST ACCOUNTING FOR INVENTORIES AND TAXPAYER-CONSTRUCTED ASSETS -- THE PROBLEMS PRESENTED BY THE REAGAN PROPOSALS

COST ACCOUNTING FOR INVENTORIES AND TAXPAYER-CONSTRUCTED ASSETS -- THE PROBLEMS PRESENTED BY THE REAGAN PROPOSALS

My name is Leslie J. Schneider. I am a member of the Washington, D.C. tax law firm of Ivins, Phillips & Barker, Chartered. I testify today as counsel to the Committee for Reasonable Inventory Accounting Rules, a diverse group of manufacturers including, among others, Eastman Kodak Company, Westinghouse Electric Corporation, Mobil Corporation, and Monsanto Company.

For several years I have devoted much of my practice to tax accounting problems in general and inventory matters in particular. During that time I have represented clients across a wide range of industries with a wide variety of cost accounting systems. I am also the author of a treatise on the federal income taxation of inventories. While at the Treasury Department's Office of Tax Legislative Counsel in the early 1970's, I was deeply involved in a study of the proper cost accounting rules for manufacturers and helped author the present full-absorption inventory regulations.

This testimony focuses on one of the most arcane and complex areas of the tax laws -- the rules for identifying and accounting for production costs of inventories and self-constructed assets. Though the area may be arcane and complex, however, I hope to spare this committee and staff the tedium of examining each tree in the dense forest of inventory cost accounting rules. Instead, I would like to back up a bit and take a look at the forest itself, to examine some basic, well-accepted principles of inventory cost accounting and to explain how the truly revolutionary changes proposed in President Reagan's tax proposals would do great and unwarranted damage to these basic principles. In the course of this brief examination, I hope to show this committee and staff that the proposed changes serve none of the three avowed goals -- fairness, simplicity, and growth -- of the Reagan tax plan. Indeed, I think it will be clear that these proposals would vastly complicate the lives of businessmen and their tax administrators without improving fairness or encouraging growth at all. They should be rejected.

Revenue

Before outlining the proposals and considering both the damage they would do to basic accounting principles and some incentive provisions of the Code and the immense complexity they would add to an already overly complex area of tax law, it is appropriate to address what may be a high priority for this committee -- revenue considerations. In this regard, we cannot ignore the fact that the proposals to revise the rules for accounting for the costs of inventories and so-called self-constructed assets would increase corporate taxes by an annual average of nearly $5 billion over the next five fiscal years (FY 1986 - 1990), according to Treasury estimates. Even for major tax reform in an era of $100 billion plus deficits, this is a significant number.

The "character" of that number is different from most of the other revenue numbers for other changes in the reform proposal, however. Changing the accounting rules for the costs of inventories and self-constructed assets is not the same as repealing the investment credit or placing restrictions on the uses of tax-exempt bonds. The inventory tax accounting rules are not incentives or "tax expenditure" programs placed in the Code by Congress to mold corporate social or economic behavior. In fact, they are not a creature of the tax law at all, but rather are a long-standing, carefully developed part of generally accepted financial accounting principles ("GAAP") used to identify "real economic income." The rules currently in effect exist, as they always have, to accurately measure income, nothing more.

As long as the income tax is assessed on an annual basis and as long as taxpayers incur costs in one year to produce products that will not be sold until a later year, some type of inventory costing rules are necessary. Whether the rules work well or work poorly can be debated wholly apart from any economic or social policy considerations. It is inappropriate to conclude, therefore, that one industry or one sector of the economy has preserved some special benefit or been granted some special Congressional dispensation if you ultimately agree with us that the proposed rules on inventory accounting in the Reagan plan do not to make sense and should be scrapped or altered. Indeed, enacting the proposed rules under these circumstances must be considered nothing more than an attempt to raise tax revenues without appearing to raise tax rates. These considerations, we think, place the estimated revenue gain from this proposal in a different light from most of the other Reagan proposals.

Outline of President's Proposals

Inventories are crucial to determine the cost of goods sold for any business where costs are incurred in one year to produce items that are not sold until a subsequent year. (The cost of goods sold, of course, is subtracted from gross receipts from sales to determine gross income from sales.) Inventories are used to determine the cost of goods sold pursuant to the basic accounting equation described below:

Beginning Inventory	$XXX
Plus: Purchases of Raw Materials	XXX
Direct Labor Costs Incurred	XXX
Overhead Costs Incurred	XXX
Total Cost of Goods Available for Sale	XXX
Less: Ending Inventory	XXX
Costs of Goods Sold	XXX

The ending inventory value is, of course, an important number in this equation. It represents the value of goods produced during the year or in earlier years that have not been sold at year end. As such, it is a deferred production cost account -- that is, it is composed of deductions that might ordinarily be taken immediately but must be deferred to a later year when they relate to products that have not yet been sold by the end of the taxable year. The more costs allocated to production costs, therefore, the greater the potential for deferral of ordinary cost of goods sold deductions.

Under current law, taxpayers must fully absorb into inventory all direct costs and certain indirect costs of producing inventoriable goods. One category of indirect costs must be included in inventory in all circumstances. Certain other costs need never be included in inventory. This category includes depreciation and amortization reported for federal income tax purposes in excess of real depreciation reported in the taxpayer's financial reports, research and development expenditures, and general and administrative expenses incident to and necessary for the taxpayer's activities as a whole. Finally, as the centerpiece of the Treasury's recognition (under current law) of the diversity of trade practices, a third category of costs must be inventoried only if the taxpayer inventories them in its financial reports. These costs include taxes, depreciation reported in financial reports and attributable to production equipment, pension and profit-sharing contributions, costs attributable to rework labor, scrap and spoilage, factory administrative expenses, salaries paid to officers attributable to services performed incident to and necessary for production, and insurance costs incident to and necessary for production.

The general rules applicable to the costing of inventories were established many years ago, primarily based on trade practice on a case-by-case basis. In the early 1970's, these rules were restudied by the Treasury Department and the comprehensive, but flexible, set of rules described above were promulgated. These rules were designed to eliminate certain abusive practices that appeared to be sanctioned by recent court cases, but at the same time maintain a degree of flexibility that would accommodate variations in trade practices. These regulations have become fully accepted and relatively well understood by both the tax and financial communities in the 12 years since their promulgation. No systematic abuses or chronic problems, either on the part of taxpayers or the IRS, have been attributed to these regulations.

Chapter 8.01 of President Reagan's tax proposals, however, would overturn these regulations - thus overturning Treasury's own relatively recent work - and impose a new set of what might be called "super' full absorption rules. The "Possible Options" spread-sheet which the Ways and Means Committee is using as a mark-up document contains the same proposal. Under these new proposals, the proposed regulations for determining capitalized costs of "extended-period long-term contracts", proposed rules which at present would apply chiefly to government contractors, would be expanded to cover the universe of manufacturing companies. The additional costs that must be capitalized under an extension of these proposed regulations to general manufacturers' inventories would include (1) tax depreciation in excess of real economic depreciation reported on financial statements, (2) pension contributions and other employee benefits,

(3) rework labor, scrap, and spoilage, (4) certain research and product development costs, and (5) direct and indirect costs incurred by any administrative, service, or support function or department that might conceivably be allocable to the production of inventories. These rules would apply to all manufacturers in all industries, regardless of their financial accounting practices.

Diversity of Trade Practices

One of the most basic and longstanding principles of the Internal Revenue Code's treatment of inventories is that the rules for determining inventory costs and values must necessarily be based on the best accounting practice in the taxpayer's trade or business. The tax law has recognized this principle since the Revenue Act of 1918 (§ 203) when the general statutory rule for inventories was first enacted. That rule remains essentially unchanged in today's Code (§ 471). The regulations echo this important theme:

> "It follows, therefore, that inventory rules cannot be uniform, but must give effect to trade customs which come within the scope of the best accounting practice in the particular trade or business." Reg. § 1.471-2(b).

For 65 years, then, the tax law has recognized that different industries and different companies are organized and operated in different ways. Sometimes this diversity is a result of history or habit; sometimes it is a result of the mechanics of producing a particular product; seldom, if ever, is the diversity a result of a conscious attempt to manipulate inventory cost accounting principles to reduce taxable income.

The diversity of acceptable inventory cost accounting methods arises from this diversity of acceptable business organization and practice. For example, some taxpayers may locate production support personnel at a manufacturing facility, while others will choose to centralize production support functions at their headquarters location. Either method can reflect good business practices. In some industries production support tasks may require face-to-face contact with production workers at the factory level; in others, the primary production support tasks may require more face-to-face contact with marketing, financial or other headquarters personnel. Logical inventory cost accounting practices in these two cases will probably have developed differently -- the factory-located manager's salary and benefits would typically be allocated to the cost of inventory while the headquarters-located manager's salary and benefits would be allocated to period costs.

This divergence of treatment of the cost of similar services is both logical and simple. It derives from the basic fact that making steel or refining oil or assembling computers are very different tasks and may involve very different considerations as to what logically are production costs and what are not. This diversity has long been accepted for financial reporting purposes by stock exchanges, the SEC and others with vital interests in the clear reflection of income. As mentioned above, it has also long been accepted for tax purposes, even after recent sharp scrutiny.

The Reagan proposal, however, would ignore this natural diversity and impose absolute uniformity -- requiring all taxpayers to account for all inventory costs identically, without reference to accepted cost accounting practices in their industry. This coerced uniformity would have several negative effects.

First, tax planning and tax abuse opportunities would be expanded. At present, there is general conformity between tax and financial cost accounting rules. Conformity between tax and financial rules operates as a natural check against overly aggressive tax planning since schemes which reduce taxable income also reduce reported earnings. Publicly-held companies, and many private companies as well, are generally reluctant to implement tax accounting procedures to reduce taxable income if the price of that reduction is concomitantly lower financial earnings. Perhaps the most marked example of this principle at work under current law is the reluctance of a great number of taxpayers to adopt the last-in first-out (LIFO) method of inventory accounting because of the financial conformity requirement.

This natural tension between the desire for higher financial income and lower taxable income would be obliterated if taxpayers are forced to use a tax cost accounting system that differs from their financial cost accounting system. This is, however, precisely what is proposed. The Reagan tax proposal's new inventory cost accounting rules would create many disparities between the tax rules and the current financial rules. As a result, this natural check of financial conformity on aggressive tax planning would be lost. This would be unfortunate since, in our opinion, the present symmetry between the tax and financial rules is a much cheaper alternative for keeping taxpayers' imaginations appropriately reined-in than a vast expansion of the IRS's audit capacity. Congress and the IRS simply cannot plug every hole through which revenue might leak -- leaving a natural brake or backstop in place is worth it even if it means sacrificing some theoretical purity (though, as we describe below, we do not think retaining current law sacrifices theoretical purity).

Second, coerced uniformity for tax purposes would transform inventory cost accounting from a dynamic body of principles able to adapt with some alacrity to new or evolving business systems (or even completely new businesses) into a fixed list of mechanical rules less able to adapt, without modification by Congress, to new or changed business circumstances. Since inventory cost accounting reaches down to the most minute and detailed level of a business's life, this ossification of the rules could present very grave dangers. Not only would Congress frequently be forced to consider the wisdom of changing rules that involve overwhelming complexity but, even given the most enlightened and expeditious Congressional attention, rule changes might never be made fast enough to keep abreast of the need for change. Tax law, unable to keep up with the changes in business systems, might even work to retard the development of those new and more efficient business systems.

Complexity

While a single, uniform rule for accounting for inventory costs may appear, at first blush, to simplify the tax accounting field, quite the opposite is true. As described above, the diversity of accepted accounting rules for inventory costs stems from the natural diversity of different manufacturing operations and different business organizations. To force a change to an arbitrary and uniform set of rules would increase complexity in several respects.

First, applying a single new set of cost accounting rules to a myriad of diverse business practices and organizations will require that the rules be written in inordinate detail. Failure to provide such detail and to embrace the concomitant immense complexity will produce confusion and uncertainty. Indeed, since no set of rules can foresee each and every potential application, any set of detailed rules must produce uncertainty. Unchaining the tax rules for inventory cost accounting from generally accepted accounting principles can only lead to greater complexity and/or uncertainty for many years to come.

Second, simply the fact of change is complex. While temporary confusion and complexity may be the price of change in any area, in cost accounting it is a particularly acute problem since the changes would affect the accounting for such a vast number of transactions for every manufacturer in the country.

Finally, and perhaps most importantly, complexity would be multiplied because the Reagan proposals contain cost accounting rules that are far more complex than those in place today. If there is any doubt on this point, simply compare the proposed regulations for the costing of extended-period long-term contracts (i.e., the rules that the Administration would apply to manufacturers) with the regulations which they replace. Few, if any, manufacturing companies have a cost accounting system in place that conforms to these new rules. This is in marked contrast to the narrow category of taxpayers for whom these rules were originally designed -- government contractors who are subject to especially elaborate Defense Department rules.

For example, under the Reagan proposals, it appears that an executive who spent part of his time overseeing manufacturing operations, part of his time overseeing construction of new plant facilities, and part of his time on general corporate strategic planning would be forced to apportion his salary and benefit costs among these various activities. Moreover, his secretary's time must be similarly apportioned, as must other indirect costs, such as depreciation on the executive's and his secretary's desk and the headquarters building's utility costs. In addition, it appears that costs of a type which are only remotely connected to the production of inventory or the construction of property through an impact on another indirect activity, such as the salaries of payroll department employees who prepare the salary checks for the employees performing the direct and indirect construction and manufacturing activities, must also be allocated to inventoriable costs. Allocation to "inventory costs" does not mean simply a shift from a period cost account to a single inventory account. The allocations must be made to the specific product's inventory account to which it relates. A diverse manufacturer, of course, can have thousands of different inventory accounts. Multiply these complex allocations by several thousand transactions for each taxpayer and you can begin to appreciate the scope of the complexity that is proposed.

Nor can it be assumed that a simple "burden rate" can be devised for computing the allocable inventoriable amount or assigning it to the correct inventory account. The relation of non-factory general and administration costs to a particular product inventory may be far too unpredictable to devise even a remotely accurate burden rate. Nor can it be assumed, particularly where different inventories have widely divergent turn-over rates, that a single burden rate without allocation to specific inventories would even approximate rough justice.

It is conservative, I think, to estimate that the proposals would impose a many-fold increase in the complexity and record-keeping requirements for inventory cost accounting for the average manufacturer. It is one thing to propose such intricate and detailed rules for government contractors who must already keep such detailed cost accounting records and make time-consuming allocations of costs because of the demands of their U.S. government customer; it is quite another thing to extend these controversial rules to all taxpayers.

Clear Reflection of Income/Dilution or Repeal of Incentive Provisions

Another fundamental and long-standing principle apparently discarded by the Reagan proposal is that income will be clearly reflected only if the real economic cost actually attributable to the production of items in inventory are allocated to those items. The proper indirect costs to be taken into account in determining the cost of inventory was the subject of a great deal of study by the Treasury Department a little over ten years ago. While, at that time, extensive advice was received from the accounting profession, the Treasury arrived at independent conclusions that are embodied in the current regulations. At no time in the past decade has it been suggested that these rules are erroneous or that they provide a potential for tax abuse.

Nevertheless, President Reagan's proposals dramatically change these rules in a very arbitrary way. For instance, it is not a settled opinion in the cost accounting profession that certain types of indirect costs, such as fringe benefits, should be allocated to inventory. Nevertheless, the Reagan proposals require such costs to be inventoried for tax purposes whether or not there is a reasonable method for allocating those costs and whether or not those costs may be fixed without regard to the amount of production.

More surprising, perhaps, is the proposed requirement to allocate tax incentive items to inventory costs. As was alluded to above, the cost of goods sold deduction is divorced from the world of special tax incentives such as percentage depletion or accelerated depreciation. The cost of goods sold is supposed to be a real economic measure that is used to help determine real economic income. A capital cost which the tax code permits to be deducted currently, rather than deferred, because of Congress's desire to provide an incentive for some activity should not affect this calculation. If it does, the calculation will be somewhat divorced from its goal of identifying real economic income while, at the same time, the effect of the special incentive will be diluted.

-- Depreciation

For example, the amount of the difference between tax and financial depreciation of factories, machinery, and equipment, typically reflects an amount that is not a real economic cost of producing goods in the factory with the machinery and equipment to which the depreciation relates. The difference typically is the capital investment incentive consciously provided in the Code by Congress. ACRS provided a great deal of incentive by increasing depreciation deductions well above real economic depreciation during an asset's early years. To the extent that the Reagan-proposed CCRS depreciation system (or any other depreciation system) retains any such incentive or non-economic depreciation feature, as admittedly CCRS does, it should not be used to determine the real economic cost of producing goods. To the extent that it is so used, as required by the Reagan inventory cost proposals, it would not properly reflect real income. This distortion violates perhaps the most basic principle under which accounting methods are judged.

Including the difference between accelerated tax depreciation and financial or real economic depreciation in the cost of inventory would also dilute the intended incentive effect of an accelerated tax depreciation system. Whenever what was intended to be an accelerated deduction is locked in inventory costs, that deduction is deferred and its intended effect reduced. If an accelerated tax depreciation system is deemed too generous, a direct adjustment would be simpler and more efficacious than such indirect dilution.

This indirect dilution of the incentive effect of accelerated depreciation will not be uniform among industries. Where product inventories turn over rapidly, as with pencils, for example, the dilution will be smaller than in industries where inventories turn over much more slowly, as with heavy machinery. This disparate effect of the dilution among industries makes the proposal more infirm, since it can hardly be assumed that Congress would intentionally design a capital investment incentive that was less generous for industries which took a long time to sell product out of inventory and more generous for those that sell products out of inventory very quickly.

Related to this point is our concern regarding the interaction of the proposed inventory costing rules with the proposed corporate alternative minimum tax. If the excess of accelerated depreciation over "real" depreciation is included as a preference item for minimum tax purposes when a substantial portion of that so-called preference is deferred in inventory, minimum tax will be imposed on a preference item that has not given rise to any "preference." Even if this can be repaired through the definition of minimum taxable income, it will seem at least a little curious that you must adjust minimum taxable income (which has always rhetorically been referred to as "real economic income") in the taxpayer's favor to adjust for an item that you insist be deferred in inventory for regular tax purposes. This can only further highlight the oddity of departing from rules which attempt to determine "real economic income" in valuing the cost of inventories.

-- Research and Development

The President's proposal appears to repeal § 174 with regard to research and experimentation allocable to self-constructed assets. Section 174 regulations already capitalize material, construction, and installation costs for self-constructed assets. The only sort of R&E costs allocable to self-constructed assets that are permitted to be expensed under § 174 are the true research labor costs of inventing the new piece of production machinery or other self-constructed asset. While "proper" accounting theory might consider this a capital cost allocable to the new machine (although query what proper accounting theory would do to the costs of unsuccessful R&E on similar production equipment), it is clear that § 174 rejects such treatment (and, coincidently, eliminates the difficult questions regarding unsuccessful R&E).

The proposal, however (perhaps unintentionally), would effectively repeal the treatment provided by § 174 by requiring such costs to be inventoried or, assuming the proposal is read to be somewhat more theoretically sound (though more devastating to § 174) by requiring that amortization deductions for § 174 costs be inventoried.

Even "minor" inroads into § 174 on such a theory is inappropriate. If, as some might advocate, some presently deductible R&E expenses on the "fringes" of § 174 ought to be capitalized as costs of self-constructed assets, we would suggest that such a task be taken on directly under § 174 and not via the back door of self-constructed asset costing rules. Section 174 represents a sound solution to very tricky questions regarding unsucessful R&D as to which costs ought to be capitalized and which immediately expensed. It also represents a conscious incentive for taxpayers to conduct R&D. Any encroachment upon § 174 therefore, must deal in depth with these issues -- a task that has not yet been started.

The proposed allocation of product development R&D to inventory costs is, perhaps, even more curious. Unlike the allocation of some machine development R&D to the cost of the machine, the proposed allocation of product development R&D to inventory cost is not even arguably correct accounting theory, without regard to the policy behind § 174. Product R&D, to the extent it is properly capitalizable at all (and again, the proper treatment of unsuccessful R&D comes into question), is capitalized as a cost of producing each item of that product for as many years as that product is produced. It is not properly capitalized in a single year's inventory costs if that product is produced and sold over a number of years.

The "proper" accounting treatment (leaving aside the unsuccessful R&D question) might be to allow product R&D to be amortized over the "life" of the product. That treatment, however, was explicitly reversed by § 174. To take any part of R&D expenditures deductible under § 174 and require them to be amortized over a lengthy period of time and to have those amortization deductions flowed through inventory simply repeals or carves back on § 174. It also can be an exercise in futility to administer such a system since the "life" of a product over which some "fringe" R&D expenditures might be amortized is, in nearly every instance, unpredictable.

Efficient Business Organization

While impossible to predict with any accuracy, the enactment of complex new uniform inventory cost accounting rules may adversely effect the way in which a taxpayer establishes and conducts its business. Since the President's proposed cost accounting rules would substantially increase the number of indirect costs which must be allocated to inventory, taxpayers may choose to organize or re-organize their operations in order to minimize the required cost allocations.

For example, in order to account for costs of self-constructed assets in a relatively simple fashion, a taxpayer may wish to create an internal plant and equipment construction division the sole responsibility of which is to build factory additions, construct production machinery equipment, or put together production lines. In many businesses, of course, creating such a separate division would be less efficient and generally more cumbersome than simply borrowing production workers on a temporary basis to reconstruct the machinery and equipment they use. However, the complexity of the

Reagan proposals and the recordkeeping burden they would produce might preclude such a freedom of choice for businesses. For tax accounting rules to promote business organization, particularly when it generally would dictate less efficient business organizations, is absurd.

Transition Method for Applying New Inventory Cost Accounting Rules to LIFO Taxpayers

If this Committee fails to reject the Reagan inventory cost accounting proposals then, at a minimum, it must rectify a major shortcoming in the transition rules proposed. Unlike the approach of the current full absorption inventory regulations promulgated in the early 1970's (Reg. § 1.471-11(e)(3)(ii)(B)), the Reagan reform proposals do not appear to provide for a cutoff transition rule for LIFO taxpayers or to make any other distinction in the application of the new inventory cost accounting rules between LIFO and FIFO taxpayers. Instead, it appears from the proposals that both FIFO and LIFO taxpayers must recompute their opening inventory using the new inventory cost accounting rules and then apply the principles of § 481 of the Code. This is in marked contrast to the transition rules proposed for long-term contracts and the costing of self-constructed assets.

This treatment is inappropriate for LIFO taxpayers for two reasons. First, if a § 481 adjustment transition approach is required, a LIFO taxpayer would need to revalue its LIFO inventories using the complex proposed rules for every year that it has used the LIFO method. Thus, for example, for a taxpayer who elected LIFO in 1940, it would need to recompute 45 years of LIFO calculations. This would be an enormous burden even if records were available. Moreover, it seems quite unlikely that a taxpayer would have preserved the type of records necessary for such a task, if in fact such records ever existed.

Second, the rationale for a § 481 adjustment does not apply for LIFO taxpayers. In the case of a FIFO taxpayer, if its beginning inventory is revalued under a new method of accounting, such revalued amount enters directly into the computation of cost of goods sold and, hence into taxable income for the current year. In order to avoid the immediate distortion to taxable income, an offsetting § 481 adjustment (taking the difference between old- and new-value inventories into income over several years) would be justified.

In contrast, if a taxpayer uses the LIFO method, any revaluation of a taxpayer's beginning inventory under a new method of accounting will not enter into the determination of cost of goods sold or taxable income unless there is a liquidation of inventory quantities into prior years' layers. In a year in which an increment occurs, a revised beginning inventory value simply becomes part of a revised ending inventory value, and, accordingly, any revaluation of the beginning inventory under a new method of accounting such as is proposed in the Reagan plan would not distort income. Absent such a distortion, there is no need for a § 481 adjustment. In fact, the imposition of a § 481 adjustment in such circumstances could itself produce a distortion in income.

The use of a cutoff transition method eliminates these problems. It should be added to the Reagan inventory cost accounting proposal in the event that proposal is ultimately enacted.

In conclusion, President Reagan's inventory costing proposals are both complex and unfair. Moreover, these proposed new rules neither eliminate a subsidy nor eliminate distortions in the proper reflection of income. They should be scrapped or significantly scaled back. If any new inventory cost accounting rules are preserved, technical transition relief must be provided for LIFO taxpayers.

Thank you for your indulgence, Mr. Chairman, members of the Committee, and staff. I know these issues are complex and difficult to comprehend, even for a seasoned tax practitioner, but I am confident that their complexity will not detract from the importance you attach to these issues. If you have any questions I would be happy to answer them.

TESTIMONY OF THE
DESIGN PROFESSIONALS COALITION

ON

THE CASH METHOD OF TAX ACCOUNTING

BEFORE THE

COMMITTEE ON

FINANCE

UNITED STATES SENATE

October 4, 1985

Chairman Packwood and Members of the Committee on Finance:

My name is James W. Poirot. I am the Chairman of the Design Professionals Coalition (DPC). My residence is Denver, Colorado, and I also serve as Chairman of the Board of Directors of the consulting engineering firm of CH2M HILL, which as you know is headquartered in Corvallis, Oregon. The Design Professionals Coalition is made up of fifty leading American Architect-Engineer companies. We individually and collectively provide our varied and highly specialized professional services to private industry and governments at all levels. Our work is both domestic and international. All of us have annual billings in excess of $5 million.

DPC welcomes this opportunity to share with you our serious concerns over and reasons for strenuous opposition to that feature of the President's Tax Proposal (Chapter 8.03--pages 212-214) which would prohibit use of the cash method of accounting for tax purposes.

SUMMARY

Virtually our entire 30,000 company profession will be adversely affected by this change. These are the design professional firms (Engineers, Architects, Surveyors and Mappers, etc.) who are the keys to our whole "built civilization." We oppose the proposed prohibition for five important reasons: (1) Detrimental impacts on the viability of many companies comprising the nation's design-related capacity; (2) Increased Federal and possibly State and local income taxes; (3) Seriously increased administrative complexities and costs--this is not "simplication"; (4) A series of general concerns, including our contesting of Treasury's claim that a change is needed to comply with "Generally Accepted Accounting Principles"; and (5) A fear that it will make us and our industry much less competitive in overseas markets.

DETRIMENTAL IMPACTS

The prohibition on cash accounting will adversely affect our industry and ultimately the entire economy.

Design firms' assets are limited to employees, reputations, contracts, some modest amounts of equipment, and, in some cases, buildings which house the staffs. We have no inventories and few capital assets. Payments for services, when received, usually constitute our only income. These are not always made promptly, and are sometimes never made. Thus, companies in our industry which will be required to pay taxes on "so-called" income, resulting from the accrual method, may be forced to adopt various "Hobson's choices." These include: increasing the costs of our product--our services, reducing employees, borrowing to pay these taxes, adopting no-growth strategies, or selling-out.

INCREASED TAXES

Enactment into law of the prohibition on use of the cash method will cost many in our industry large amounts of money. A recent survey was conducted by Design Management Consulting Inc., Marieta, Georgia, for a coalition comprising The American Institute of Architects, American Consulting

Engineers Council, American Society of Civil Engineers, American Society of Landscape Architects, American Congress on Surveying and Land Mapping, Design Professionals Coalition, National Socieity of Professional Engineers, and Professional Services Management Association. We believe this to be representative of the industry as a whole.

It found that 83 percent of the responding architecture and engineering firms that currently file taxes on a cash basis would suffer accelerated tax liability as a result of the Administration's proposal on accrual accounting. Of these responding firms, 62 percent reported they would experience "substantial" tax increases.

For example, my own company, CH2M HILL, will owe an estimated $9 million in additional taxes over the next six years. We would be forced to borrow money to pay taxes on non-existent cash income. Added costs of interest will certainly increase the costs to our clients, thus impacting the economy as a whole. When asked how they would pay these augmented taxes, 35 percent of those firms polled indicated they would borrow funds rather than raise fees or use working capital. Another 19 percent said they would combine borrowing with working capital or fee increases to meet the tax burden. Several firms also noted that ceasing operations would be seriously considered. Limitations on available capital will most certainly inhibit innovation and development of new approaches and techniques.

Analysis of available data on the industry suggests that the proposal would result in a potential industry-wide increase in current taxes of $700 million. This is believed to represent 92.8 percent of last year's net profits for the total industry! Clearly, this proposal would have devastating effects.

While the approximately 400+ A-E firms with average gross receipts over $5 million (which collectively employ about 50% of our industry) will be impacted, the proposal's second qualifying provision will impact many among the entire 30,000 company profession. According to the survey, 83 percent will be affected. If limited to just large firms (over $5 million), they, including many of our member firms, will be much less competitive than companies under the $5 million threshhold.

ADMINISTRATIVE CONCERNS

Administrative problems and costs would abound. This is hardly tax simplification for the companies involved! Numerous sophisticated adjustments would be required to change from the cash to the accrual method of tax accounting.

The effect on State and local tax returns would be nightmarish. In addition to Federal tax returns, many A-E firms file numerous State and local tax returns as well. While changing the calculation of Federal taxable income to an accrual basis would be difficult enough, the ramifications involved with having to perform calculations for preparations of multiple State and local annual returns, based on different methods of tax accounting, would be staggering. In effect, firms would have to keep separate books and records just to file their State and local returns. For States where companies could continue to use the cash method of accounting, their sales factors for income apportionment purposes, based on cash receipts, could not easily be reconciled to the Federal return.

At a time when companies like ours are trying to reduce administrative overhead costs, such a major tax change could be extremely difficult and costly to implement. The full administrative costs of implementing the accrual basis of accounting for our company and others cannot be easily estimated. We can, however, safely state that such costs, both initially and on an ongoing basis, would be significantly higher than they are under current tax laws.

GENERAL CONCERNS

The rationale for the President's Proposal includes several claimed reasons why large companies should not be allowed to use the cash method of tax accounting.

One suggested reason why such a dramatic change is necessary is that the cash accounting method is not in accordance with Generally Accepted Accounting Principles (GAAP). While it is true that cash accounting is not in accordance with GAAP, neither are: (1) Installment sales; (2) Tax treatment of deferred compensation; (3) Gain deferrals on like kind exchanges; (4) Pension and ESOP accruals; and (5) Transactions with related parties.

It should be noted that GAAP came into existence for purposes of external audit opinions, not for tax collection purposes; it has the basic objective of using conservatism when measuring the financial operations of an entity. Therefore, DPC believes that the argument that cash accounting is not consistent with GAAP is not a convincing argument in support of the proposed change.

It is also argued that the cash receipts method "frequently fails to reflect the economic results of a taxpayer's business over a taxable year," and that "the cash method simply reflects actual cash receipts and disbursements, which need not be related to economic income." However, what is a better measure of economic reality than cash actually being paid or received? This is especially true in an industry such as ours where a firm's assets are, as I indicated earlier, usually its employees, contracts, a few buildings and some equipment, and where payments for our services are sometimes late or never received.

Accrual accounting would force us to recognize and pay taxes on "income" from a client or customer that may never be received. Cash accounting does not have this problem. If the proposal is limited to those companies above $5 million, it seems odd and unfair that cash accounting could reflect economic income for small companies but not for large ones. In addition to its simplicity, cash basis accounting is consistent with the "wherewithal to pay concept." This concept recognizes that taxpayers are in the best position to pay taxes after they have collected income and paid expenses. In the alternative, if forced to use accrual tax accounting, can we pay our taxes in "units of accrual" rather than cash?

Until recently, deductions for accrued interest or expenses payable to a cash-basis related party were disallowed unless the accrual-basis taxpayer actually paid the cash-basis taxpayer within two and one-half months within the end of the tax year in which the accrual occurred. Now, the deduction is deferred until the related party recognizes the income. Thus, if a liability to pay interest arises in one year, but is not paid until a later year, the accrual-basis taxpayer is not allowed a deduction until he actually makes the payment to the cash-basis related party. In essence, the accrual-basis taxpayer is placed on the cash method for expenses payable to a related party.

Furthermore, the Administration's proposal would have the unintended impact of lowering tax revenues received by the U.S. Treasury because many firms would be forced to borrow funds to pay tax liabilities on uncollected fees. Since interest on loans is deductible, the Federal Government would receive less tax revenue over time.

OVERSEAS COMPETITION

Member firms do considerable work abroad. It should be noted that design contracts are critical to our nation's competitiveness in overseas markets. It has long been understood that engineering studies and reports are the key to design contracts and follow-on work. American firms generally specify U.S. products and thus give a competitive edge to both American construction companies bidding for such work and domestic suppliers of materials and equipment. Overseas work promotes our economy by generating jobs at home and the services trade helps to make up for our serious trade deficits in manufactured products.

American companies must currently struggle against unfair competition by other nations which subsidize interest rates, provide free engineering studies and refrain from taxing income of their overseas workers. Obtaining payment for overseas work is often quite difficult and in far too many cases takes much longer than for domestic clients. Sometimes payments are never received. Thus, requiring U.S. design firms to pay taxes on "economic income," which is not promptly or sometimes never received, will handicap American firms even more.

CONCLUSION

DPC does not believe that the President's Proposal recognizes the nature of our business and the devastating effects on it and the economy from such a costly and sweeping change for taxpayers who currently recognize income and expenses by use of the cash basis of tax accounting. It will increase the price of our services, place costly and cumbersome burdens on us and numerous other design companies, cause stagnation in the industry, and make us much less competitive in world markets.

Mr. Chairman and Members of the Committee, we urge you to oppose disallowance of this established, well-understood, easily-administered, and economically-viable cash method of tax accounting. Thank you again for holding hearings and giving us the opportunity to express these views.

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STATEMENT OF THE DIVISION OF TAXATION (DIVISION 16) OF THE DISTRICT OF COLUMBIA BAR

CONCERNING

THE PRESIDENT'S PROPOSAL TO LIMIT THE USE OF THE CASH METHOD OF ACCOUNTING[1]

Under Chapter 8.03 of the President's Tax Proposals to Congress dated May 29, 1985 ("the President's Proposal"), the following taxpayers would be required to compute their taxable income on the accrual method: (1) business and professional organizations having annual gross receipts (computed on the basis of a three-year moving average) of $5 million or more, and (2) businesses (other than farming businesses) which use the accrual method in preparing reports to owners, creditors or others.

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[1] STANDARD DISCLAIMER

The views expressed herein represent only those of Division 16, Taxation, of the District of Columbia Bar and not those of the entire District of Columbia Bar or its Board of Governors. The Division of Taxation is composed of approximately 1,153 members.

Under the cash method of accounting, income is recognized in the year in which it is actually or constructively received, and expenses are deducted in the year in which they are paid. This is in contrast with the accrual method of accounting which generally requires the inclusion of an item in income or a deduction when all events fixing either the right to receipt or the obligation to pay are fixed and the amount thereof is determined with "reasonable accuracy."[2/]

Under the President's proposal, every business required to convert its method of reporting taxable income to the accrual method of accounting would be required to pay a one-time tax, to be spread over a six-year period, on the balance of its receivables less its accounts payable on the effective date of the change. In the case of businesses operating as partnerships, such a one-time tax would have to be paid by the partners in such partnerships, and not by the partnerships themselves which only file information returns.

[2/] A number of special rules have been developed, however, which (i) permit cash-flow tax accounting by accrual-method sellers of goods (e.g., installment sales); (ii) permit sellers of goods to take into account inflation in computing the deduction for cost of goods sold (e.g., LIFO accounting); and (iii) protect the government from the loss of revenues from "premature accruals" (e.g., section 461(h) of the Internal Revenue Code). In addition, both the Internal Revenue Service and the courts have generally required accrual-method taxpayers to report prepaid income on the cash basis. See Section II of our discussion, infra, with respect to the discrimination which is imposed upon cash-basis taxpayers by the President's Proposal when their treatment is compared with that of accrual-basis sellers of goods who will still be permitted to use the installment method in reporting their income.

Chapter 8.04 of the President's Proposal proposes to deny to accrual-basis taxpayers the right to maintain a bad-debt reserve.

The President's Proposal concludes that the industries which would be primarily affected by a mandate to change to the accrual method for tax purposes would be banks that use an accrual basis of accounting for financial reporting and large service organizations, such as accounting, law and advertising firms. Thus, the President's Proposal mistakenly provides an inference that it will affect only a few types of taxpayers. As a matter of fact, the General Explanation of the President's Proposal greatly understates the reach of the provision which would directly affect the entire service sector of the economy, including architects, engineers, contractors, plumbers, electricians, temporary-help services, maintenance services, repair crews, insurance claim adjusters, credit-reporting agencies, television and radio broadcasting stations, health-care providers, doctors, dentists, etc.

The Division of Taxation of the District of Columbia Bar opposes Chapters 8.03 and 8.04 of the President's Proposal as applied to personal-service businesses (and particularly to law firms with which the Division of Taxation is most familiar), because the Division of Taxation believes that such proposal is unsound for the reasons discussed below. The Division of Taxation offers no opinion with respect to the application of the President's Proposal set out in Chapters 8.03 and 8.04 to other forms of service.

I. THE CASH METHOD OF COMPUTING TAXABLE INCOME IS A CLEAR REFLECTION OF THE INCOME OF PERSONAL-SERVICE BUSINESSES.

A. Conformity Of An Accounting Method To Generally Accepted Accounting Principles Does Not Necessarily Mean That Such Accounting Method Is A Clear Reflection Of Income For Tax Accounting Purposes.

Chapter 8.03 of the President's Proposal concludes that the cash method does not clearly reflect income because "the cash method of accounting is not considered to be in accord with generally accepted accounting principles and therefore is not permissible for financial accounting purposes." In so concluding, the President's Proposal suggests a need for greater conformity between tax and financial accounting. The President's Proposal appears to be premised upon the mistaken assumption that accrual accounting for tax purposes is in accord with (or more in accord with) the economic concepts of income recognition and generally accepted accounting principles than is the cash method. This is not the case, since, as we point out, *infra*, accrual *tax* accounting is not necessarily consistent with accrual *financial* accounting, *e.g.*, the use of the installment method by accrual-basis sellers of goods is not in accord with generally accepted accounting principles. More importantly, however, as we also point out, *infra*, the Supreme Court has clearly stated that tax and financial accounting have different purposes and employ different characterizations of various items. Thus, the conclusion of the President's Proposal quoted above is incorrect because *the key test of whether a method of accounting is acceptable for tax-reporting purposes is whether it clearly* reflects income, and not whether it is necessarily in accord with generally acceptable accounting principles.

Contrary to the position expressed in the President's Proposal, adherence to generally accepted accounting principles does not necessarily mean that an accounting method clearly reflects income for tax purposes. In order for an accounting method to be in accordance with generally accepted accounting principles, it need only fairly present the results of operations; there is no requirement that it clearly reflect income either for tax or for other purposes. Indeed, the Congress itself has implicitly recognized that (i) conformity to the best accounting practice and (ii) a clear reflection of income for tax purposes are two independent and unidentical standards because, in drafting section 471[3/] applicable to inventory accounting, it required that inventory accounting meet both standards. Had the Congress believed that an inventory accounting method which was in conformity with generally accepted accounting principles necessarily was a clear reflection of income for tax purposes, it would have had no need to have imposed in section 471 an obligation that a taxpayer meet both

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[3/] All references to "section" are to sections of the Internal Revenue Code of 1954, as amended; all references to "Reg. §" are to the Treasury Regulations on Income Tax promulgated thereunder; all references to "C.B." are to the Cumulative Bulletin which is a consolidation of the Internal Revenue Bulletins published by the Department of the Treasury in carrying out its responsibilities to interpret the Internal Revenue Code enacted by Congress; all references to "acquiesced" are to actions of the Department of the Treasury accepting conclusions reached by the courts in tax disputes.

criteria. Another example of the Congress' recognition that adherence to generally accepted accounting principles does not necessarily clearly reflect income is the fact that our Federal tax law does not recognize all of the reserves required by generally accepted accounting principles.

Indeed, the United States Supreme Court has recognized that adherence to generally accepted accounting principles does not necessarily mean that a taxpayer has clearly reflected its income. In American Automobile Association v. United States, 367 U.S. 687, 693 (1961), the Court stated: "This is only to say that in performing the function of business accounting the method employed by the Association 'is in accord with generally accepted commercial accounting principles and practices.' It is not to hold that for income tax purposes it so clearly reflects income as to be binding on the Treasury." In so holding, the Supreme Court adopted a position urged upon it by the Executive Branch of our Government, namely the Department of the Treasury as represented by the Department of Justice. Later, in Thor Power Tool Co. v. U.S., 439 U.S. 522 (1979), the Court stated that identical methods need not be used for the determination of taxable income and the preparation of financial statements.

Thus, it is altogether fair to state that, until the President's Proposal was sent to the Congress on May 29, 1985, the Executive Branch of our Government was in agreement with the long-standing view of both the Congress and the Judiciary that an accounting method does not have to be in accordance with generally accepted accounting principles in order to clearly reflect income.

B. The Cash Method of Accounting, As Currently Used by Personal Service Businesses, Clearly Reflects The Income Of Those Businesses.

It is the view of the Division of Taxation of the District of Columbia Bar that the cash method of accounting as currently used by a majority of personal service businesses clearly reflects the income of those businesses, even if the cash method may be determined not to be in accordance with generally accepted accounting principles. Indeed, the cash method historically has been recognized as presumptively correct for service businesses, and numerous court decisions, as well as published and private rulings of the Internal Revenue Service, recognize that, for the service industry, the cash method clearly reflects income.

The cash method is simple and fair in both application and result. It accurately represents a taxpayer's annual disposable income. While the accrual method is often used in accounting for non-personal-service businesses (because accounts receivable and payable are indicators of both a business' current financial condition and its future prospects), nevertheless, accounts receivable and payable, in the context of a personal-service business, are merely indicia of accretion to wealth and not of current spendable income.

That the cash method clearly reflects income is substantiated by the fact that owners of personal-service businesses generally deal with one another on the cash basis, such as in the case of entry and departure of partners in a partnership. Newly admitted partners generally share in fees collected after their admission, even though the services generating such fees were performed prior to their admission, and withdrawing partners rarely have continuing interests in receivables on hand at their withdrawal dates. Periodic changes in partners' interests in partnerships generally apply only to cash collections following such changes and not to receivables as of the dates of such changes. Moreover, even if such partnerships were placed on the accrual basis, because the partners in such partnerships do not have a right to uncollected amounts, uncollected amounts would not be includable in such partners' income under normal accrual methods of accounting as applied to such partners.

Since, under the President's Proposal, the uncollected fees owed to a partnership as of December 31, 1985 will be taxable to each partner in such partnership over the following six years, regardless of whether such partner performed services generating such fees, the additional taxes will have no relationship to the "earnings" of such partner. Instead of being a tool of simplicity, the President's Proposal, if enacted, may cause confusion by forcing service businesses to change their normal business practices in order to compensate partners for the taxes due on income which such partners did not receive. Thus, a change to the accrual method will actually distort the income of personal-service businesses. In contrast, the cash method has been the long-accepted method of tax accounting for personal-service businesses because it does not distort taxable income.

The President's Proposal fails to point out any significant abuses on the part of those taxpayers currently using the cash method. Moreover, the Division of Taxation of the District of Columbia Bar knows of no evidence to support a conclusion that a significant number of personal-service businesses artificially defer the receipt of taxable income by originating billings late in the year in order to generate fee payments in the following taxable year. In fact, many personal-service businesses maintain aggressive billing and collection practices. As professional service organizations grow, there is an even greater need to accelerate the collection of income to meet increasing expenses and less of an opportunity to defer the collection of income from a large number of clients. Indeed, the accounts received of large service organizations are generally lower at year end than at any other time during the year. Moreover, to the extent that there may be taxpayers who are presently abusing the cash method, it is altogether possible that there would be an equal number of abusive taxpayers under the accrual method, if it were adopted.

The clear-reflection-of-income argument propounded by the Administration in Chapters 8.03 and 8.04 is inconsistent in itself. On the one hand, the Administration argues in Chapter 8.03 that the accrual method most clearly reflects income, because such method adheres to generally accepted accounting principles. On the other hand, however, the Administration, in

Chapter 8.04, proposes to deny to accrual-basis taxpayers the right to maintain a reserve for bad debts, which reserve is mandated if an accrual method is to operate in accordance with generally accepted accounting principles. The impression created by this inconsistency is that the Administration is not so much interested in a "simplified" method of accounting which clearly reflects taxable income as it is in collecting the most tax dollars. Maximizing tax collection would appear to be masquerading as tax reform.

Moreover, the proposal to deny a bad-debt reserve will, most likely, create controversial factual issues before both the Internal Revenue Service and the courts relating to whether bad-debt losses are actually sustained. If personal-service businesses accounting for their taxable income on the accrual basis are forced to litigate the collection of their claims in order to sustain their bad-debt deductions -- even though statistical proof shows that only a small percentage of billed and uncollected fees are ever collected -- then the Division of Taxation suggests that the bad-debt deduction will become more, rather than less, complicated.

A question of consistency is also presented by the lack of direction in the President's Proposal with respect to the treatment of cash retainers paid in advance of the performance of the services to which such retainers relate. It appears that, under the President's Proposal, fees paid in advance may be fully taxable in the year when paid, absent the applicability of Rev.

Proc. 71-21, 1971-2 C.B. 549, even though proper accrual accounting practice dictates the establishment of a liability to represent the obligation of the payee to perform future services against which such retainers would be applied. Thus, the President's Proposal may produce the anomalous result of the application of the cash method where it will generate the earlier reporting of income than under the accrual method and the application of the accrual method where it will generate the earlier reporting of income than under the cash method. Such a result is hardly consistent with a professed policy of "matching." Once again, maximizing tax collection may be masquerading as reform, and income will not be reflected as clearly as it is currently reflected by personal-service businesses operating under the cash method.

Even though, as we have shown, the cash method clearly reflects the income of personal-service businesses for tax-accounting purposes, the President's Proposal appears to be predicated on the assumption that the income of such personal-service businesses would be more clearly reflected for income tax purposes if such businesses were to use the accrual method of accounting, rather than the cash method. The Internal Revenue Service's previous attempts to force taxpayers to change from one method of accounting which already clearly reflects income to another which the Service feels more clearly reflects income have been consistently rejected. Brown v. Helvering, 291 U.S. 193 (1934); Garth v. Commissioner, 56 T.C. 610 (1971), acq., 1975-1

C.B. 1; Photo-Sonics, Inc. v. Commissioner, 357 F.2d 658 (9th Cir. 1966); Auburn Packing Co. v. Commissioner, 60 T.C. 794 (1973), acq., 1974-2 C.B. 1. Indeed, the Service itself, in explaining its position in acquiescing in the result of Auburn Packing, recognized that it lacks the authority to challenge the consistent use of a method of accounting specifically authorized by the Regulations. Rev. Rul. 74-505, 1974-2 C.B. 154. Accordingly, there is no basis at law for the attempt by the President's Proposal to change the accounting methods used by personal-service businesses, even assuming arguendo that the change proposed by the President would more clearly reflect income for tax-accounting purposes than the cash-method currently used by such personal-service businesses.

Moreover, even if the premise of the President's Proposal were correct -- namely, that the test for tax-accounting purposes is which accounting method most clearly reflects income, and not merely which accounting method clearly reflects income -- under such premise of the President's Proposal, the Proposal itself does not provide for as clear a reflection of the taxable income of personal-service businesses as is currently the case under cash-method, because the Proposal offers no guidance as to the application of the accrual method beyond the statement that "[c]onsideration will also be given to taking into account the billing of clients for services... ." The unanswered question -- which cannot properly be left "hanging" until regulations are issued -- is whether, under the Administration's concept of the accrual method, service businesses must accrue earned, but unbilled, income at the time that the services generating such income are performed, or whether such businesses need only accrue earned income when they bill their clients. The value of work-in-process is, in the opinion of the Division of Taxation, too contingent to mandate its accrual. The value of work-in-process is undeterminable under the principles of accrual accounting, because the value is generally dependent on such factors as completion of an entire undertaking; the accomplishment of a particular result; the occurrence of a subsequent event which may be beyond the control of the service provider, such as the issuance of a permit or contract; or an adjustment prior to formal billing either by the service provider alone or by the service provider in consultation or negotiation with the client.

By the same token, undue complexities would be entailed under the President's Proposal if, after services were billed by a service provider in one taxable year, a client were to protest, and the service provider were to adjust, the fee or claim it as a bad debt in a subsequent taxable year. If a reserve for bad debts were permitted, such an adjustment would have been taken into account by an experientially based addition to the service provider's bad-debt reserve. But, if no reserve for bad debts is permitted, then how will a service business be permitted to reflect a fee adjustment in a year subsequent to the year of billing in computing its income? Unless a fee adjustment is treated as an ordinary and necessary business expense in a year subsequent to billing, if service businesses are forced to prove the uncollectability of amounts which they charge off, then the Division of Taxation suggests that such businesses' income will not be clearly reflected for tax purposes, because often a billed fee, although collectible, may be reduced in a subsequent year by a service provider merely in order to avoid discord and preserve goodwill.

In determining what method of accounting most clearly reflects the taxable income of a service business, the President's Proposal fails to take into account the basic difference between manufacturing businesses and personal-service businesses. While it may be appropriate for a manufacturer to accrue income from the sale of a tangible product which may be recovered or resold in the event that such accrued income is not eventually collected, this is not the case with a service business which has nothing tangible to show for its efforts prior to the collection of its fees.

II. THE PRESIDENT'S PROPOSAL DOES NOT PROMOTE FAIRNESS AMONG TAXPAYERS

The President's Proposal discriminates against the sellers of services. Sellers of property who reflect their income on the accrual basis are permitted to elect the installment method of reporting their income[4/] which ties the recognition of taxable income to the receipt of payments of cash. Thus, sellers of property have been effectively placed on a modified cash method of reporting income. In contrast, there is no provision in the President's Proposal which would permit service businesses to use the installment method. Accordingly, taxpayers will be treated inequitably. An additional provision by the Congress at this point, in order to "right the wrong" by permitting service business to report their income on the installment method, would only increase the complexity of the Internal Revenue Code at the price of a modest change in tax revenues.

While manufacturers of tangible products are often able to defer payments relating to inventory production simultaneously with their accrual of expenses, this is not the case with personal-service businesses which have ongoing expenses for salaries and rent which cannot be deferred. Increased tax obligations resulting from the necessity to accrue uncollected income will place an inequitable burden on personal-service businesses vis-a-vis their manufacturing counterparts.

The ultimate taxpayers affected by such inequitable treatment will be consumers of personal services. Because

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[4/] It bears mention that the installment method is not in accord with generally accepted accounting principles even though it has been viewed by the Congress as contributing to the clear reflection of taxable income. This further underscores the difference between the clear-reflection-of-income test for tax-accounting purposes and the depiction of financial condition for financial-accounting purposes.

service businesses will have an increased cash liability for taxes, due to the imposition of the accrual method, there is a strong likelihood that the increased tax cost of doing business will be implicitly reflected in higher base fees and that such service businesses will also be forced to impose late payment fees. Service providers will become no different than department stores and oil companies which distribute credit cards. They will impose a charge on their clients if such clients fail to pay their bills within a reasonable period of time.

The $5 million gross-receipts dividing-line criteria unfairly discriminates against successful businesses. The message will be: If service businesses are too successful and their receipts become too large, they will be forced to compute their taxable income in a less-favorable manner. Such a result goes against the grain of the basic capitalistic tenets of our economy and ensures that business decisions as to size and growth will be influenced by tax considerations, rather than by sound business judgment. Indeed, the Proposal might actually encourage large partnerships to subdivide into smaller partnerships solely in order to avoid the $5 million threshold. Growth will be discouraged. This is precisely the type of decision-making that the President's Proposal was designed to eradicate.

Moreover, the President's Proposal would also create severe problems for taxpayers whose businesses are cyclical. Such taxpayers could be forced to change to the accrual method, because a "spurt" of growth may push them over the $5 million threshold, and may then be unable to obtain the consent of the Commissioner of Internal Revenue to change back to the cash method, despite their return to their consistently lower level of revenues.

Lastly, the Division of Taxation believes that the President's Proposal will impact severely on those residents and workers in the District of Columbia. Much discussion has centered around the impact of the President's Proposal on large businesses which gross in excess of $5 million annually. The fact is, however, that the President's Proposal will have a deleterious effect not only on law firms but also on many small businesses which currently use the accrual method for financial-accounting, but not for tax, purposes. These small businesses, of which there are many in the District of Columbia, will be overcome by the requirement that they change to accrual accounting, and pay the one-time tax associated with such change-over, merely because they may have used the accrual method to develop financial statements which they have submitted to lenders. Thus, those taxpayers who are the least stable financially may be among those most severely affected by the proposal. This is, in our opinion, altogether unfair.

III. THE ADMINISTRATION'S CONCERN ABOUT THE MISMATCHING OF INCOME AND DEDUCTIONS IS UNREALISTIC

It has been alleged by the Administration that the cash basis of accounting for income used by personal-service businesses promotes the mismatching of income and deductions.

First, in the case of many personal-service businesses, there is no "mismatch" at all because many of the billings for personal services go to clients for whom such fees are not tax-deductible because they are personal or because they may have to be capitalized.

Second, a perfect "mismatch," where the payor and the payee use the same taxable years, is altogether rare. Moreover, to the extent that the President's Proposal will not extend to personal-service businesses which have not used the accrual method or whose gross receipts do not reach the $5 million level, it will do nothing to correct "mismatching" in such instances. This consideration is particularly important in light of the Administration's statement that "[t]he proposed restriction on the use of the cash method of accounting would affect only a small percentage of firms."

Third, when the Congress recently examined other tax situations involving the short-term "mismatching" of various items of income and expense, it properly avoided imposing needless complexity. Consider, for example, section 467 (prepaid rent); section 461(h)(3)(A)(ii) (the accrual of expenses for certain recurring items before the commencement of economic performance); and sections 1272-1275 (original issue discount), all of which exempt short-term differences in treatment from mandatory "matching" rules.

Lastly, even if a "mismatching" argument were relevant, the President's Proposal will itself create "mismatching" where it does not presently exist. If, as the Administration has stated, only a small number of businesses will be affected by the restriction on the use of the cash method, the income of some service businesses will be accelerated, while a larger number of payors will not be eligible for concurrent deductions.

IV. THE PROPOSAL PROMOTES COMPLEXITY, RATHER THAN SIMPLICITY IN TAX REPORTING

The President's Proposal promotes complexity in tax reporting in the following instances.

1. As noted earlier, complexity will evolve in the cases of accounting for bad debts, charge-offs and unbilled fees.

2. The accrual method in itself is more complex than the cash method, as the Proposal itself admits.

3. By forcing one group of service businesses to change to the accrual method as soon as income reaches $5 million, the Proposal will generate constant problems as more businesses have to change their method of accounting year after year from cash to accrual back to cash. As we have pointed out, even further problems will be encountered by businesses which inadvertently become subject to the accrual method due to a series of unusually large and nonrecurring fees. The statute will require extensive attendant regulations defining such terms as the "regular use of financial accrual," work-in-process and other accruable fees.

In conclusion, the position of the Division of Taxation of the District of Columbia Bar is that: (1) the proper test for tax-accounting purposes is the clear-reflection-of-income test, and not either an adherence-to-generally-accepted-accounting-principles test or a "clearest"-reflection-of-income test; (2) the cash method of accounting currently used by a larger number of personal-service businesses clearly reflects the income of those businesses; (3) even if the clearest-reflection-of-income test were applicable, the cash method more clearly reflects the income of personal-service businesses than does the accrual method; (4) the President's Proposal is inherently inconsistent and unfair; (5) the President's Proposal may promote, rather than correct, "mismatching;" and (6) the President's Proposal may lead to greater complexity, rather than simplicity, in tax reporting.

With respect to personal-service businesses, the cash method is not broke. It ought not to be "fixed" unnecessarily.

STEERING COMMITTEE
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STATEMENT OF ECONOMICS LABORATORY INC. ON DEDUCTIBILITY OF BUSINESS MARKETING MEALS

COMMITTEE ON FINANCE

October 4, 1985

Economics Laboratory is a chemical specialty firm engaged primarily in environmental sanitation. We provide detergents and cleaning systems to a wide variety of commercial, industrial and institutional customers including hotels, restaurants and hospitals. We also have a consumer product line including the dishwashing detergents Finish and Electrasol, and other household products.

The Treasury Department has proposed to limit the deductibility of business marketing meals. They propose a cap of $25 per person (including tax and gratuities) on full deductibility of business marketing meals and propose to limit the deductibility of amounts above $25 per person to fifty percent. No deductions would be allowed for hospitality suites and other business receptions, and indexing is not provided. By 1988, the $25 cap would shrink to $17.15 plus tax and gratuities.

Treasury's proposal is based on the general tax policy principle that tax law should not influence business decisions. If Treasury wishes to apply this principle to business marketing decisions, the proposal to limit the deductibility of business marketing meals should be withdrawn. Limiting deductibility makes business marketing meals relatively more expensive than other business marketing expenses that continue to be fully deductible as an "ordinary and necessary" business expense under Section 274 of the Internal Revenue Code.

The National Restaurant Association requested Chase Econometrics to analyze the Administration's proposal. Results of this analysis are summarized in Table 1, attached. The estimates are based on a 10 percent reduction in business meal purchases annually. During the first three years of the proposal, direct losses in restaurant sales would total $11.9 billion and direct losses in restaurant employment would total nearly 460,000 person-years. The reduction in restaurant sales would produce a direct drop in state and local sales tax receipts of over $700 million. Indirect employment would be reduced by 580,000 person-years for the first three years. Federal corporate taxes would rise about $2.6 billion, but would be more than offset by a rise in transfer payments of $2.4 billion and reductions in personal income taxes of $2.2 billion and social security taxes of $2.3 billion, for a net Treasury loss of $2.8 billion. Impacts on state and local government would be a net loss of $3.2 billion.

Economics Laboratory, Inc. is affected by the administration's proposal because they are the leading supplier of cleaning systems to eating and drinking establishments. For every dollar of restaurant income, 55 cents are paid to suppliers, such as Economics Laboratory. By comparison, restaurants pay only thirty cents of that dollar to employees, and just four cents in indirect business taxes. The remaining ten cents is rent on owner-occupied structures, profits, and corporate income taxes.

The cost of purchasing a cleaning system from Economics Laboratory is very small when compared to costs of other restaurant needs such as food. However, the restaurant industry is extremely price sensitive. The Treasury Office of Tax Analysis has indicated in a study reviewed by Chase Econometrics that for every one percent increase in the price of a meal, spending on business marketing meals declines by two to four percent.

Reducing the deductibility of meals above the $25 cap is equivalent to an increase in their price of 25 percent. Hence, the proposed $25 per person cap would result in a drop of 50 to 85 percent in purchases of business meals above the cap, even though the drop in total business marketing meals is 9 to 15 percent annually.

Economics Laboratory sales are more closely related to business marketing meals than to purchases of all meals. First, Economics Laboratory accounts are concentrated in metropolitan areas where the concentration of business marketing meals is much larger. Secondly, Econ Lab products are purchased primarily by first class eating and drinking establishments which can and do buy the best products available. Other establishments also prefer Econ Lab products, not because they cost more, but because they are the best value. These establishments have made Economics Laboratory the market leader in sales of cleaning systems. If the Treasury proposal is enacted, and a restaurant's business is cut in half, even a first class establishment will seek a less expensive alternative.

The Administration's proposal to limit deductibility of business marketing meals will have a direct effect on Economics Laboratory sales and on shareholder income. As a corporation, it is our responsibility to protect our shareholder investments, and our duty, as well as our privilege, to communicate our concerns to Congress.

The Administration's proposal to limit the deductibility of business marketing meals should be withdrawn, not because it would lower sales, but because it is ineffective in achieving Administration goals of raising tax revenues, simplifying the tax system, and improving the public's perception of fairness. We believe that the per person cap of $25 encourages tax abuse, and interferes with business judgment on what proportion of the marketing budget should be spent on business meals.

Economics Laboratory, Inc.
St. Paul, Minnesota

TABLE 1

ECONOMIC IMPACT OF BUSINESS MEALS CAP UNDER "TREASURY II"

(with meals cap versus without)

	1986	1987	1988	Total
Direct Impacts on Sales, Employment, and Tax Receipts*				
SALES OF MARKETING MEALS ($ Billions)				
Total Projected Sales	33.2	36.8	40.7	110.7
Sales Lost Due to Cap	-3.5	-3.8	-4.6	-11.9
Sales Retained	29.7	33.0	36.1	98.8
DIRECT EMPLOYMENT (Thousands)				
Eating & Drinking Establishments	-144	-146	-166	-457
DIRECT TAX RECEIPTS ($ Billions)				
Federal Tax on Meals Over Cap	.25	.28	.26	.79
State & Local Sales Tax on Meals	-.21	-.23	-.27	-.71
Macroeconomic and Government Revenue Impacts, including Indirect**				
GNP ($ Billions)				
Current Dollars	-1.7	-3.31	-5.84	-10.85
1972 Constant Dollars	-.65	-1.1	-1.57	-3.32
EMPLOYMENT (Thousands)				
Total U.S.	-150	-190	-240	-580
Wholesale & Retail Trade	-150	-160	-190	-500
Unemployment Rate (Percent)	.09	.1	.11	na
FEDERAL BUDGET ($ Billions)				
Personal Income Taxes	-.51	-.69	-.99	-2.19
Corporate Income Taxes	.85	.87	.84	2.56
Social Security Taxes	-.53	-.73	-1.06	-2.32
Total Federal Taxes	-.19	-.55	-1.20	-1.95
Transfer Payments	.87	.76	.72	2.35
Federal Net (deficit)	-.87	-.79	-1.17	-2.83
STATE & LOCAL BUDGET($ Billions)				
Personal Income Taxes	-.34	-.49	-.7	-1.53
Corporate Income Taxes	.13	.12	.11	.36
Indirect Business Taxes	-.37	-.52	-.73	-1.62
Total S&L Taxes	-.59	-.90	-1.34	-2.83
State & Local Net	-.68	-1.07	-1.46	-3.21

Totals may not add due to rounding

* Estimates prepared by Shriner-Midland Company.

** Macroeconomic simulations by Chase Econometrics.

STATEMENT OF

RICHARD G. MULLIGAN

ON BEHALF OF THE FINANCIAL EXECUTIVES INSTITUTE
COMMITTEE ON GOVERNMENT BUSINESS
SUBMITTED FOR THE RECORD TO THE
UNITED STATES SENATE
COMMITTEE ON FINANCE
HEARINGS REGARDING TAX REFORM - ACCOUNTING ISSUES
OCTOBER 4, 1985

As Chairman of the Committee on Government Business of the Financial Executives Institute, we appreciate the opportunity to submit comments for the record to the committee. The Financial Executives Institute (FEI) is a professional organization of over 12,500 individual members who are senior financial and administrative officers of over 6,000 companies that represent virtually all segments of the economy. The Committee on Government Business is authorized to form on behalf of FEI, statements or positions relative to existing or proposed federal legislation and regulations designed to mandate: 1) accounting principles, standards or practices; 2) recordkeeping and reporting; and 3) other financial-related rules to be followed by private business enterprises providing goods and services directly or indirectly to the federal government. It is this professional background and experience that qualifies us to address this topic.

In addition to FEI's concerns regarding the budget deficit, our membership is following closely the issue of tax reform and simplification. Although FEI has taken no formal position on the President's Tax Reform Proposal, the Committee on Government Business maintains that certain sections of the tax reform proposal relating to the use of the completed contract method impose new restrictions which needlessly discriminate against long term contractors. These provisions, relating to the capitalization of interest and general and administrative expenses, are intended to correct a perceived abuse of the completed contract method which enable certain contractors to pay little or no federal income tax.

In 1982 there was some feeling in Congress and perhaps elsewhere that contractors were overly aggressive in their interpretation or application of the completed contract regulations and, as a result, were in some cases inappropriately delaying taxation. Consequently, the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) mandated new regulations which would measurably reduce the benefits of the completed contract method, particularly in the area of the current deductibility of period costs, completion requirements, and the severing and aggregating contracts.

As an example of how much stricter the TEFRA regulations are, let me use the example of the manufacturing of a spacecraft as a means of demonstrating TEFRA's impact. In addition to the normal problems inherent in estimating profit on such sophisticated and highly technical products, most of the profit or loss on these contracts is determined by the spacecraft performance in orbit after they are completed and launched.

It usually takes three to five years to manufacture the spacecraft and the period of orbital performance is an additional three to five years on most contracts. If the spacecraft does not function properly, there is a substantial penalty that must be paid and the maximum profit can only be earned if the spacecraft operates perfectly for the entire period of orbital performance. Is it fair or equitable to "estimate" successful performance and pay the tax while the spacecraft is being manufactured only to have to file for a refund if the spacecraft fails at a later date? The regulations implementing TEFRA state "final completion" shall be determined without regard to any performance incentives such as "spacecraft orbital performance" which forces contractors to make such estimates of performance.

Because of their magnitude, the TEFRA changes made in 1982 were phased in over a three year period - 1983-1985. The full impact of TEFRA on the completed contract method is only now materializing. As a result, companies that had a low effective tax rate due to the use of the completed contract method in the past are now paying substantial federal income taxes and will continue to do so in the future. It is indeed unfortunate that much of the current criticism of the use of the completed contract method of accounting by defense contractors is based on outdated information.

The Citizens for Tax Justice (a nonprofit, tax reform/abuse organization) prepared a schedule of defense contractors who paid little or no taxes for 1981 through 1983. The schedule was published in the Wall Street Journal on June 18, 1985, and other newspapers and, as a result, several bills were introduced to eliminate the method completely for defense contractors. (See attached Exhibit Number 1.) It should be noted that two of the three years in the survey (1981-1982) were covered by tax laws that did not include the significant increase in taxes required by the TEFRA adjustments to the completed contract method of accounting mentioned above. In addition, the completed contract method was not the cause for reduced taxes in a number of companies listed. General Electric, did not even use the completed contract method. General Electric presumably paid little or no taxes because it was the largest participant in the safe harbor leasing provision enacted in the 1981 tax act to enable loss companies to obtain the benefit of the investment tax credit. GE bought the investment tax credits from Chrysler and other companies who could not use them because they were in a loss position. Subsequently, the provision permitting this alternative was eliminated.

The schedule of defense companies also included the Lockheed Corporation. However, it should be noted that Lockheed did not adopt the completed contract method until 1982. Its tax position for the years covered by the survey had been governed primarily by massive losses suffered on the L-1011 commercial airplane program, not the completed contract method.

Most defense contractors paid higher income taxes in 1984 and will continue to pay increased taxes on their long term contracts as the three-year phase in of TEFRA adjustments continues (See attached Exhibit Number 2). As evidence, the Joint Tax Committee has estimated that budget receipts relating to the more restrictive TEFRA CCM provisions would increase by $800 million in fiscal year 1983, $2.2 billion in fiscal year 1984, and by approximately $2.5 billion in each of the fiscal years 1985, 1986, and 1987.

The Citizens for Tax Justice, with their usual fanfare and wide publicity, recently released their 1984 report. The headlines read, "Fifty Major Companies Pay No Taxes" and several defense contractors were cited. However, if one looks behind the headlines, included in their report is a section entitled, "Notes on Individual Companies." I have summarized the notes of the companies in the defense business, (See attached Exhibit Number 3). As you can see, these notes confirm my earlier statements that TEFRA is working and defense contractors are paying substantial income taxes on their long-term contracts.

The Committee believes that the retention of the completed contract method, without further modifications, is sound tax policy. We also strongly oppose any of the current proposals calling for the elimination of this long standing method, especially those that discriminate against the defense industry. Under CCM, which was first permitted for the construction and building industries in 1918, the profits earned under long term contracts are not taxable until they can be determined with resonable accuracy, at the time of contract completion and acceptance by the customer. In 1976, the aerospace and shipbuilding industries were also permitted to use this method. Today, it is used almost universally in these industries. The completed contract principle is based on both economic and technological realties. The extraordinary uncertainties present in industries using the completed contract method arise because each project or contract is unique. A contractor is confronted with a variety of unknown situations, each of which can present its own set of design, engineering, construction or performance risks. It is economically unjustifiable to require recognition of taxable income and payment of tax on the basis of estimated progress toward the presumed, but by no means assured, profitable completion of a never before designed or manufactured product. This is also at variance with the established principle that neither income nor expense is recognized for tax purposes until the time that is is reasonably fixed and determinable. The IRS has historically resisted attempts by taxpayers to use estimates in accounting for income or deductions. Thus, it would be inconsistent to now require the use of these estimates in selected and unique situations. A clear reflection of taxable income can only occur through the use of the completed contract method.

I have already provided the justification for Completed Contract Method of Accounting, as amended by TEFRA. What I would like to emphasize now is that the reported taxable income has little relationship to the cash we receive from progress payments.

Specifically, I would like to address the subject of progress payments in relation to the Completed Contract Method of Accounting. Some people have inferred that progress payments in conjunction with Completed Contract Method of Accounting provide contractors a special benefit at the expense of the taxpayer. In addition, there are those in Congress who believe that the receipt of progress payments somehow obligates the contractor to pay income tax on these payments.

Progress payments reimburse the contractor for only 80% of the incurred cost. The difference between the cost incurred and the cost reimbursed through progress payments represents billions of dollars in our industry. The interest expense to finance this investment is an unallowable and a nonreimbursable cost.

While progress payments reimburse the contractor for a portion of his costs, these payments have nothing to do with profit or taxable income. If there were no progress payments, contractors would borrow the funds necessary to pay their contract costs, and still determine their taxable income or loss when the contract is completed.

The construction, shipbuilding, and aerospace industries' tax treatment should parallel that of other U.S. manufacturers. Manufacturing profits are taxed only when a sale has been completed, at the end of the production process. Income taxes do not accrue ratably over the production cycle. The continued availability of the completed contract method will serve to place long term contractors on an equal basis with the majority of the other U.S. manufacturers. The completed contract method in no way permits contractors to escape taxation on their earnings and it is not a tax subsidy. It merely allows the deferral of tax payment until the contract is completed and profit is known. We strongly urge the members of this Committee to support the continued use of the completed contract method of accounting under the rules prescribed by TEFRA.

Should the Committee have further questions, FEI will be pleased to respond for the record.

STATEMENT OF

HOUSING AMERICA FOUNDATION

COMMITTEE TO PRESERVE HOMEOWNER BONDS

before the

COMMITTEE ON FINANCE

UNITED STATES SENATE

on

THE TAXATION OF INSTALLMENT OBLIGATIONS

October 4, 1985

Mr. Chairman and Members of the Committee:

My name is Jon Grove. I am appearing today on behalf of the Committee to Preserve Homeowner Bonds of the Housing America Foundation. I am Board Chairman of the American Southwest Financial Corporation, a group of seventy-seven builders of single family and multi-family homes in 33 states across the country which issues homeowner bonds, and Executive Vice President of Estes Homes, an Arizona home builder.

I want to thank you for the opportunity to discuss the proposal in the Administration tax plan regarding the recognition of gain on pledges of installment obligations. I will focus on the proposal as it relates to the home mortgages which are pledged as collateral for homeowner bonds, also known as "builder bonds".

Homeowner bonds were developed as a financing mechanism in response to the recession of the late 1970's and early 1980's, which drove 30% of all homebuilders out of business. The prime rate reached a record high of 21.5% during that period. Lenders severely curtailed fixed rate mortgage money. Builders and first-time home buyers found it increasingly difficult to find affordable mortgages. Clearly, there was a critical need for a new source of mortgage funds. Homeowner bonds were a private sector response.

Under this method of financing, builders hold the mortgages on the homes they build and sell. They use these mortgages as collateral for bonds that are issued to obtain capital for additional home construction. Builders then take back the mortgages on these new homes and use them as collateral for future bond issues. The proceeds of these future issues are in turn used to provide financing for additional homes. Interest on the bonds is fully taxable. As with other mortgages they hold, builders recognize gain on an annual basis, as payments are made by the home buyers.

Small and medium-sized builders, who do not have adequate size to issue the bonds themselves, are able to take advantage of this financing method by pooling their mortgages together in a cooperative manner. American Southwest Financial and HOME MAC, which was established by the National Association on Home Builders, were specifically designed to provide an opportunity for such small and medium-sized builders to participate in this program.

Of importance for the national economy, this mechanism has worked for the American home buyer. Builders using this source of financing have been able to offer more favorable interest rates to homebuyers than traditional lenders. They have been able to do this for several reasons:

- Fees and costs which formerly had to be paid to mortgage bankers and other middlemen have been substantially reduced.

- The cost reduction, which is gained on those mortgages that are prepaid, is an incentive to issue lower interest mortgages

- Deferral by the homebuilder to future years of a portion of its income makes it possible for builders to issue mortgages at lower interest rates.

First-time homebuyers in the $18,000 to $40,000 income range have benefitted the most. The majority of the homes built under this program cost $80,000 or less, a price range typically available to first-time homebuyers.

The efficiency of controlling the cost of a home through this kind of direct financing is well-documented. A recent study of more than 14,000 mortgages issued between 1983 and 1985 by members of American Southwest in 33 states demonstrated that builders who have issued the bonds have been able to offer mortgages at rates ranging from 1/2% to 1 % below prevailing market rates. This lowering of rates has enabled thousands of additional home buyers to qualify for mortgage loans. I have included the study, undertaken by the accounting firm of Kenneth Leventhal & Co., as part of my statement.

A buyer who saves 1% on a 30 year mortgage on a home costing $80,000 will ultimately save nearly $25,000 over the life of the mortgage. While many homeowners pay off their mortgages over the full 30 years, the average 30 year mortgage is actually paid off in 12 years. A buyer of an $80,000 home paid off in twelve years will save nearly $9,000.

The change proposed by the Administration would affect the tax deferral aspects of installment sales. The proposal would require that taxes on the profit made by a builder, based on the percentage of the mortgage for which the proceeds of the bond are received, be paid when the bond is issued. As noted, under current law builders pay taxes as down payments and the payments on the mortgage are made and the profit is actually received by the builder.

Under the homeowner bond program, the builder still owns the mortgage securing the bond when the bond is issued. The proposal would therefore mean that the builder would be taxed on the profits of an asset which has not been relinquished. Under our system of taxation, the borrowing of money does not constitute a taxable event. The proposal put forward by the Administration carves out a special exception to this fundamental principle. It would treat the proceeds of a loan as if they were "payments" on the mortgages.

This is inconsistent with the long-standing rule regarding recognition of gain and contradicts both the letter and the traditional intent of the tax treatment of installment sales.

We are concerned that the primary reason for the proposal is to restrict the use of homeowner bonds. Corporations in other industries have used the existing installment sales treatment for years, and have borrowed against their receivables through a variety of methods. Now builders have developed a program which uses the installment sales rules, and uses them in a manner which lowers mortgage rates. The response of Treasury has been to propose to limit its use -- and to limit it in a way that is not applicable to many of these other corporations. This change would take away an effective home financing tool and put builders and home buyers in a less competitive position than other borrowers.

Builders would recognize gain under the proposal because, based on the size of most builders, lenders require the specific pledging of mortgages as collateral for the bonds. The financing subsidiaries of large well-capitalized corporations in other industries would be forced to recognize gain only if they give the lender a general lien against their installment obligations. The proposed change would not apply to borrowings by a financial subsidiary in which the lender is not specifically given a general lien against its installment obligations.

As a result, the proposal would apply differently to different types of industries and to different-sized businesses. Generally, the larger the business, the less likely it is that the provision would apply to it. This is because the financing subsidiaries of many large corporations which have substantially all their assets in the form of installment obligations are able to borrow on their "general credit", rather than against any of their specific installment obligations. They are able to do this because of their size, reputation and borrowing history. However, if they default, the lender would have the right to place a lien on any assets of the financing subsidiary including its installment obligations.

The purpose of the proposed change is to withhold the installment sales treatment for those installment obligations which are "cashed out." The assets of the financial subsidiaries of many large corporations often borrow as much as 90% of the value of their installment obligations. When these financing subsidiaries borrow, they are engaging in the same techniques for which the Administration is proposing to tax builders and others who are forced to specifically pledge their installment obligations. Whether or not the subsidiary is required to give the lender a general lien, its installment obligations are still in effect "cashed out" by the borrowing. However, these financing subsidiaries would continue to pay taxes on the profits of their installment obligations on an installment basis.

The distinction drawn by Treasury, based on the pledge of specific assets at the time of borrowing, is not meaningful, and worse is discriminatory, given the purpose of this proposal. Whether a lien on installment obligations is explicitly given as security by the borrower at the time of borrowing, or available to and imposed by the lender at the time of default, bears no relation to whether the installment obligations serve as the ultimate security for the loan. It is the collateral that lenders will look to in both cases in the event of a default.

Against the loss to the housing industry and to moderate-income home buyers resulting from restricting the homeowner bond program, Treasury is estimating a comparatively small revenue gain from the proposal.

Treasury has thus far not responded to requests by the homebuilding industry for the basis of its revenue estimates. We believe that the revenue estimates may be overstated. Against these estimates, a study done by Dr. Scott Brown of the Federal National Mortgage Association, using the Wharton national econometric model, concluded that between 1984 and 1988 an additional 61,000 housing units will be built solely because of the availability of this financing method. The study also concluded that the construction of these additional units will generate 127,000 new jobs and will increase the gross national product by 2.4 billion dollars; as a result, the model calculated, the federal deficit will decrease by 2.1 billion dollars.

The benefits generated by the homeowner bond program are well-documented. This proposal would clearly diminish the effectiveness of this new private sector financing method. It would do so in a manner that would be prejudicial to the homebuilding industry and home buyers. For these reasons, we urge that the Committee maintain present tax law and not adopt the proposed change in the tax treatment of installment sales.

IFDA

INTERNATIONAL FOODSERVICE DISTRIBUTORS ASSOCIATION

a Division of National-American Wholesale Grocers' Association

DATE: OCTOBER 18, 1985

STATEMENT OF: Mr. Neil Port, President,
Sky Brothers, Inc. Altoona, PA

BEFORE THE: Committee on Finance
United States Senate

SUBJECT: The deductibility of business, meals in the President's Tax Proposal for Fairness, Growth and Simplicity.

Mr. Chairman, Members of the Committee, ladies and gentlemen.

I am Neil Port, representing the International Foodservice Distributors Association of which I am the Chairman of the Government Affairs Committee. Also, I am president of Sky Brothers Incorporated, Altoona, Pennsylvania. I would like to thank the chairman and the committee for allowing me to present the collective views of our membership in opposition to any change in the laws and regulations governing the deductibility of business marketing meals.

The International Foodservice Distributors Association (IFDA) is a national trade association comprised of foodservice distributor companies whose primary line of business is the supply of away-from-home eating establishments, such as restaurants, throughout the United States. IFDA, operating as a division of the National-American Wholesale Grocers' Association, represents more than 300 member companies doing approximately $10 billion in annual sales. IFDA provides research, technical, educational, and government services to its members.

Sky Brothers is a full line foodservice distributor with facilities in Altoona, Allentown, and Pittsburgh, Pennsylvania. Our primary service areas outside our home state are West Virginia, Maryland, New Jersey, and parts of New York and Ohio. We have 4 million cubic feet of warehouse space, a sophisticated data processing center, and a 150-unit truck fleet. However, the real backbone of our operations is people: our employees, our customers, and their customers. Sky Brothers has been recognized twice, in 1978 and 1981, by the foodservice industry as Innovative Distributor of the Year. Since 1930 we have provided quality service and products to our customers, allowing us to grow to the largest distributor in Pennsylvania with annual sales of more than $130 million.

I would like to begin my testimony with a discussion of the history and enforcement of the deductibility of business meals.

HISTORY AND ENFORCEMENT

Prior to the adoption of section 274 of the Internal Revenue Code the deductibility of business meals was mainly governed by section 162(a) for trade or business expenses and, in some instances, by section 212 for nonbusiness production of income expenses. Both sections 162 and 212 require that the expense must be "ordinary and necessary" in order to be deductible. "Now, what is ordinary, though there must always be a strain of constancy within it, is nonetheless a variable affected by time and place and circumstance. Ordinary in this context does not mean that the payments must be habitual or normal in the sense that the same taxpayer will have to make them often." [Welch v. Helvering, 290 U.S. 111, 113, (1973)]. "As the word 'necessary' is used here,...it means 'appropriate' and 'helpful'". [Blackmar v. Comm., 70 F.2d 255, 257 (2d Cir. 1934)] "Whether an expenditure is directly related to a business and whether it is ordinary and necessary are doubtless pure questions of fact in most instances. [Comm v. Heinger, 320 U.S. 467, 475 (1943)].

The Tax Court disallowed an Air Force medical officer the deduction of food and drink expenditures incurred in entertaining his associates even though it was customary in the Air Force to do this type of entertaining. However, the District Court allowed an anesthesiologist the deduction of expenditures for a cabin and a speed boat on a lake and other items for the entertainment of his associates.

In the Richard A. Sutter case, a doctor, practicing industrial medicine, entertained his business associates and deducted expenditures for food and entertainment for himself and his guests. The Tax Court allowed only the portion of such expenses that exceeded what would have been spent for his personal purposes. Since deciding Sutter, the Tax Court has consistently followed this rule. The Fourth Circuit Court of Appeals, in disallowing a deduction for the cost of meals and lodging to taxpayers who individually owned and operated a hotel, stated the Sutter rule applied to a deduction for food and lodging expenses claimed under section 119. The Ninth Circuit Court of Appeals, citing Sutter, allowed a traveling salesman, who had no "tax home," the deduction of only that portion of food and lodging expenses under section 162 which 'was, in fact, attributable to the exigencies of business. The problem of determining the portion of an expense that is extraordinary, and thus deductible, imposes an almost impossible burden of proof on the taxpayer.

The George M. Cohan case is one of the most frequently cited cases in the field of federal taxation. In the Cohan case the Board of Tax Appeal refused to allow Cohan any part of his claimed $50,000 estimated travel and entertainment expenses. On appeal to the circuit Court of Appeals for the Second Circuit, Judge Learned Hand, in his opinion for the Court, said:

"The Board refused to allow him any part of this on the ground it was impossible to tell how much he had in fact spent, in the absence of any items or details. The question is how far this refusal is justified, in view of the finding that he had spent much and that the sums were allowable expenses. Absolute certainty in such matters is usually impossible and is not necessary; the Board should make as close an approximation as it can, bearing heavily if it chooses upon the taxpayer whose inexactitude is of his own making. But to allow nothing at all appears to us inconsistent with saying that something was spent. True, we do not know how many trips Cohan made, nor how large his entertainments were, yet there was obviously some basis for computation, if necessary by drawing upon the Board's personal estimates of the minimum of such expenses. The amount may be trivial and unsatisfactory, but there was basis for some allowance, and it was to refuse any, even though it was the traveling expense of a single trip. It is not fatal that the result will inevitably be speculative; many important decisions must be such."

In Paletti v. Commissioner, the Eighth Circuit Court of Appeals reversed the decision of the Tax Court and directed it on remand to apply the Cohan rule to determine the portion of previously proven business and personal expenditures that were deductible under section 162. The Tax Court had earlier determined that an unknown portion of such expenditures constituted deductible business expenses but then had erroneously failed to allow any portion thereof. The practical effect of the Cohan rule has resulted in taxpayers claiming excessive entertainment expenses having only a slight relationship with their business with the hope that at least a portion of such expenses would be allowed as a deduction. This has resulted in superfluous disputes and litigation in the administration of the federal tax law, especially in the area of mixed personal business expenditures.

The history preceding, and the legislative process during, the enactment of section 274 is both interesting and illuminating. During World War II, claims for travel and entertainment deductions grew because of the excess profits taxes. After the War, the "T & E" industry continued to grow so that by the mid-1950's, expense account spending was estimated at between five billion and ten billion dollars a year. This resulted in a yearly tax loss of up to $2 billion. When the press focused its attention on the problem, it turned from a "national joke" to an outright "scandal."

In his first tax message to Congress, President Kennedy declared war on the expense account. Secretary of the Treasury Dillon emphasized that certain deductions conferred substantial personal benefits that were largely personal living expenses. The President, with his original proposals, confronted the mixed business-personal problem directly and proposed that the deduction for all entertainment facilities be eliminated, business gift and a ceiling be placed on travel expenses.

After a stormy debate, the President's proposals were rejected by Congress. The Senate Finance Committee believed that complete disallowance would discourage business transactions and result in unemployment in the entertainment industry. The House bill originally proposed that no deduction would be permitted for entertainment and similar expenses unless the expenses were "directly related to the active conduct of the taxpayer's trade or business," which would have generally eliminated any deduction for goodwill entertaining and similar expenses. This concept was generally adopted by the Conference Committee agreement, which was enacted.

Section 274 provides for limitations on, and disallowance of, deductions for certain entertainment activities, entertainment facilities, business gifts, foreign travel, and attendance at foreign conventions. However, there are some exceptions; most notable for the purposes of this article is the exception for business meals.

Under section 2749(a)(1)(A), no deduction is allowed with respect "to an activity which is of a type generally considered to constitute entertainment, amusement, or recreation, unless the taxpayer establishes that the item was directly related to...the active conduct of the taxpayer's trade or business." This is known as the "directly related" test, which has four requirements:

1. Proximity--taxpayer has more than a general expectation of deriving income or a business benefit (other than goodwill) from the expenditure.

2. Conduct of business--taxpayer was conducting business or was prevented from doing so by reasons beyond his control.

3. Amount of business--the principal aspect of the entertainment was business.

4. Exclusion of nonbusiness guests--the expenditure is allocable to the taxpayer and others with whom he anticipates engaging in business.

Section 274(a)(1)(A) also provides that an entertainment expenditure may be deducted if it "was associated with the active conduct of the taxpayer's trade or business." This is known as the "associated with" test which has two requirements.

1. Purpose--taxpayer has a clear business purpose in making the expenditure.

2. Association--the entertainment either precedes or follows a bona fide business discussion.

After 1978, standard 274(A)(1)(B) provides that no deduction shall be allowed for an entertainment, recreational, or amusement facility except in the case of a country club facility which meets the "directly related to" test of section 274(a)(1)(A), supra. Such restricted facilities include yachts, hunting lodges, fishing camps, swimming pools, tennis courts, and bowling alleys, and may include airplanes, automobiles, hotel suites, apartments, and houses (such as beach cottages and ski lodges) located in recreational areas, but does not include tickets to sporting events.

Section 274(b) limits business gifts to twenty-five dollars a year for each recipient.

Sections 274(c) and (h) limit the deductibility of expenditures for foreign travel and attending conventions, seminars, and similar meetings held outside the United States to a maximum of two such activities per year per individual and also limits amounts that may be deducted for each such activity.

Section 274(c) provides for nine exceptions to the limitations of section 2749(a). The first exception is known as the "quiet business meal" exception.

"(1) Business Meals--Expenses for food and beverages furnished to any individual under circumstances which (taking into account the surroundings in which furnished, the taxpayer's trade, business, or income-producing activity and the relationship to such trade, business, or activity of the persons to whom the food and beverages are furnished) are of a type generally considered to be conducive to a business discussion."

The Conference Report said, regarding the business meal exception, that "the cost of providing food and beverages at most business meetings and banquets would be deductible, as well as almost all restaurant and most hotel entertainment...nor...is there a requirement that business must actually be discussed in order to get a deduction." Treasury Regulations require that the food and beverage must be furnished "under circumstances of a type generally considered conducive to business discussion," that the "surroundings in which the food or beverages are furnished must be such as would provide an atmosphere where there are no substantial distractions to discussion," and that "the relationship of the persons to whom the food or beverages are served...must be such as will reasonably indicate that the food or beverage were furnished for the primary purpose of furthering the taxpayer's trade or business and did not primarily serve a social or personal purpose." Internal Revenue Service guideline questions and answers released in 1963 relating to the business meal exception to section 274(a) indicate that the business meal can be for the purpose of creating goodwill, that it is possible that the business meal can take place in the taxpayer's home, and that the expenditures of the guest's wife and the taxpayer's wife may be deductible under some circumstances. However, one commentator believes that there is really very little difference between meeting the "conducive to business discussion" test necessary to qualify the deduction under the "business meal" exception and the "directly related" tests required to qualify other entertainment deductions under section 274.

The purpose of section 274(d) was the abolition of the Cohan rule for determining the amount of allowable entertainment, travel and gift expenses. For these expenditures to be deductible, the taxpayer must substantiate the following elements for each such expenditure: amount, time and place of travel or entertainment, or date and description of gift; business purpose; and business relationship to the taxpayer of each person entertained, or receiving a gift. The Internal Revenue Service has broad statutory authority in section 274(d) to waive all or a portion of its requirements. However, it generally has adopted elaborate rules for substantiation of such expenditures. To substantiate the deduction for a business meal, the taxpayer "must record the cost, the date, the name, and place of the restaurant or hotel, etc., a description such as lunch or dinner, and the occupation or other information relating to all the persons entertained, including names, titles, or other designations sufficient to establish business relationship to the taxpayer. The business purpose need not be separately stated where it is evident from the business relationship of the persons entertained." The actual records required for substantiation are complex. Taxpayer must prepare or maintain an account book, diary, statement of expense, or similar record in such manner that each recording of an element of an expenditure is made at or near the time of an expenditure (contemporaneous record). Unless not readily obtained documentary evidence must be obtained for any expenditure of twenty-five dollars or more. A restaurant receipt, supported by a cancelled check for payment thereof, which contains the "name and location of the restaurant, the date and amount of the expenditure, and, if a charge is made for an item other than meals and beverages, is an indication that such is the case." There are several relief provisions to the recordkeeping rules in certain cases, i.e., loss of records, and use of other evidence of equally probative value.

Instructions given by the Internal Revenue Service to its agents for auditing returns claiming deductions for entertainment expenditures at restaurants and night clubs is enlightening. Its Audit Technique Handbook, effective June 13, 1977, says:

"(a) Restaurants and night clubs--the examiner should review the 'check' (statements of charges). This review should disclose the date, name, and location of the place where the entertainment took place and the amount of the expenditure. A restaurant check will usually list the number of persons served. The examiner should determine whether or not the taxpayer was present and if a specific business purpose existed during the entertainment activity. The taxpayer's diary, account book, or similar record should be examined to determine the business circumstances surrounding the entertainment activity. With respect to this and other forms of entertainment, the examiner should be alert for reciprocal arrangements involving nothing more than social functions."

The courts have generally used section 274(d) as the basis for disallowing business meal deductions. In Dowell, Jr. v. U.S., the Fifth Circuit denied the deduction of expenditures for business lunches, admittedly ordinary and necessary business expenses, because adequate records were not maintained. Even, "a virtual blizzard of bills, chits and other papers relating to Dowell's meals with other persons, was not enough to satisfy section 274(d) because each separate expenditure was not documented as to person entertained, specific date, amount and location by diary or appointment book. However, in La Forge v. Comm., the Second Circuit allowed a surgeon to deduct the approximate amount of hospital cafeteria lunches purchased each duty day by him for his assistants who regularly ate with him. His only evidence to substantiate the cost of those lunches was the oral testimony of the cafeteria cashier, who said each lunch cost between $2.65 and $3.00 per day, and his own. The Second Circuit said that section 274(d) contemplated that adequate substantiation could also be made in certain cases by oral and circumstantial evidence. But, later, in Steel v. Comm. and in Hughes v. Comm., the Second Circuit denied deductions for business meals and food items because the oral testimony of the taxpayers, coupled with some checks, was inadequate substantiation under section 274(d).

The Sutter case rule may still be applied by the Internal Revenue Service after enactment of section 274. The Internal Revenue Service in June 1963 announced that its past and future practice in applying the Sutter case rule was and would be in the future "largely to abuse cases where taxpayers claim deductions for substantial amounts of personal living expenses." However, in La Forge v. Comm., supra, the Second Circuit remanded the case to the Tax Court to determine the amount La Forge "would have been required to spend in any event for his sustenance" for which "no deduction will be allowed." This opinion made no mention of the Internal Revenue Service practice of applying the Sutter case rule largely to abuse cases. The Tax Court in Marom v. Commissioner cited with approval the Sutter case rule and agreed with the Internal Revenue Service that it was an "abuse" case but did not define what constitutes an "abuse" under the Internal Revenue Service practice. In Fenstermaker v. Commissioner, several executives of a public electric utility would frequently meet for lunch across the street from their office, where they would discuss the business of their employer. They received reimbursement for these lunches. The Tax Court found that the reimbursement of the cost of the executives' own lunches was additional income to them because of the Sutter case rule. Taxpayers contended that their case was not an "abuse" case but the Court ruled that the Internal Revenue Service cannot change the basic principle of the Sutter case rule and was not bound by its prior rulings. The Fenstermaker case forcefully demonstrates that the Sutter case rule can be applied by the Internal Revenue Service whenever it desires and to any business lunch when the taxpayer deducts the cost of his own meal.

IFDA believes, under current law, in which business is allowed the maximum freedom to operate, safeguards are in place to prevent abuse.

Current Law and Practice

Many business organizations produce goods and services that are not designed for the mass market and cannot effectively use the mass media to promote their wares.

The local realtor or insurance agent, producers of products used to make other products, suppliers of specific services to business and industry and others often must use one-on-one contact to close their deals. The business marketing meal provides the environment for mutual understanding and respect. Business is enhanced or new business is created.

Anyone who has capital at risk is currently entitled to this deduction (as are his agents) in the same manner as deductions for the cost of labor, raw materials, rent, or promotional expenses. They are all legitimate expenses of doing business.

The business marketing meal, hospitality suites, and business sponsored receptions are all part of the marketplace. If businessmen and women did not believe these expenditures were good for their businesses they simply would not be made. If a business is frivolous, lavish, or extravagant in the utilization of these promotional tools, the free market has a good answer to the problem: these businesses go out of business.

Some members of the public--and some in the Treasury Department--apparently believe the business marketing meal is simply an uncontrolled waste of money. President Carter's "three Martini Lunch" comments helped foster this attitude.

However, that belief flies in the face of common sense and good business judgement. These dollars are budgeted within the business like every other business dollar. The budget for business marketing meals competes for priority with every other budget item. Whether that budget process is formal or informal is irrelevant. The bottom line is: If the business didn't think it was a good idea, it simply would not spend the money.

The fact that a great deal of money is spent on the business marketing meals is proof that business considers the marketing meal an important part of its success.

Businesses control the business marketing meal costs as they control all other costs of doing business: Carefully. People are fired for abusing expense accounts.

IFDA opposes limiting the deduction for business marketing meal expenses (including tax and tip) to $25 per person with a 50 percent deduction for amounts that exceed this cap for the following reasons:

I. Current deductibility allowances are fair.

   A. The business meal is a legitimate marketing tool. Like other sales-generating expenditures that are fully deductible (advertising, promotions, free samples, etc.), the business meal is an integral part of many firms' marketing plans.
   B. The proposed cap is neither fair to the restaurant industry nor to business people. No other service industry is singled out for such limitations, and no other area of business marketing is faced with such an arbitrary spending ceiling.

II. Current deductibility allowances are equitable.

   A. The deduction can be used by any class or profession, provided the meal is a legitimate business expense.
   B. Placing a dollar limit on the deduction would hurt many business people, particularly independents, who rely on restaurant meals to attract clients or customers rather than on other forms of promotion that may be inappropriate or too expensive.
   C. The cap discriminates against restaurateurs and businesses that operate in high-cost areas, such as large cities where meal tickets are higher.

III. The business meal deduction is not widely abused.

   A. There are no IRS data or congressional studies which indicate abuse is a problem.
   B. The deduction is self-regulating because a company that allows its employees to abuse their expense accounts will lose money.
   C. Stricter enforcement of existing laws is the answer to abuse, not curtailing the deduction.

IV. The cap would result in significant sales, job, and tax revenue losses.

A. Restaurant sales would drop by $3.5 billion in the first year and by as much as $11.9 billion over three years as businesses shifted their marketing dollars to fully deductible expenditures (Chase Econometrics study).

B. Approximately 146,000 restaurant jobs would be lost in the first year as a result of the cap (Chase Econometrics).

C. Job losses would be particularly hard-felt by foodservice employees. Foodservice is one of the largest employers of teens, women, and minorities--those least able to withstand economic dislocation. Foodservice employs more minority managers than any other industry, and half of all foodservice managers and administrative personnel are women.

D. Loss of local, state, and federal income tax dollars and increased welfare and unemployment benefit expenses would result in a net revenue loss of $1.6 billion in the first year and $6 billion over a three-year period (Chase Econometrics).

V. The cap would lead to further limits on the business meal deduction.

A. The cap is not indexed for inflation and thus would become more restrictive as menu prices rose.

B. Congress could lower the $25 ceiling at any time or eliminate the deduction altogether.

Further the President's proposal will create a nightmare of recordkeeping in trying to sort out, and keep track of, the portion of business marketing meal expenses which are fully deductible and that portion which is partially deductible.

Those responsible for tax policy are attempting to judge better than the marketplace how promotional and goodwill dollars are to be spent. In the process, they are penalizing the business person who has found the business marketing meal to be an effective tool to enhance business relationships.

Economically, the President's proposal to cap business meal deductions will cost federal, state and local governments. A study by Chase Econometrics for the National Restaurant Association shows a loss in revenues of over $6 billion to the governmental treasuries as well as a much greater loss of 140,000 jobs in the foodservice industry.

Business meals purchased either for travel or marketing account for about one-third of total U.S. restaurant sales. Business marketing meals account for just over one-fifth of restaurant sales nationally and a substantially higher share of restaurant sales in major cities. Business meals are recognized as a productive cost of doing business. In 1985 business and professional firms will spend more than $30 billion for marketing meals in U.S. restaurants, supporting some 1.3 million restaurant jobs.

TABLE 1

ECONOMIC IMPACT OF BUSINESS MEALS CAP UNDER "TREASURY II"

(with meals cap versus without)

	1986	1987	1988	Total
Direct Impacts on Sales, Employment, and Tax-Receipts*				
SALES OF MARKETING MEALS ($ Billions)				
Total Projected Sales	32.2	36.8	40.7	110.7
Sales Lost Due to Cap	-3.5	-3.8	-4.6	-11.9
Sales Retained	29.7	33.0	36.1	98.8
DIRECT EMPLOYMENT (Thousands)				
Eating & Drinking Establishments	-144	-146	-166	-144
DIRECT TAX RECEIPTS ($ Billions)				
Federal Tax on Meals Over Cap	.25	.28	.26	.79
State & Local Sales Tax on Meals	-.21	-.23	-.27	-.71
Macroeconomic and Government Revenue Impacts, including Indirect**				
GNP ($ Billions)				
Current Dollars	-1.7	-3.31	-5.84	-10.85
1972 Constant Dollars	-.65	-1.1	-1.57	-3.32
EMPLOYMENT (Thousands)				
Total U.S.	-150	-190	-240	-580
Wholesale & Retail Trade	-150	-160	-190	-500
Unemployment Rate (Percent)	.09	.1	.11	n/a
FEDERAL BUDGET ($ Billions)				
Personal Income Taxes	-.51	-.69	-.99	-2.19
Corporate Income Taxes	.85	.87	3.63	5.35
Social Security Taxes	-.53	-.73	-1.06	-2.32
Total Federal Taxes	-.19	-.55	1.58	.84
Transfer Payments	.87	.76	.72	2.35
Federal Net (Deficit)	-.87	-.79	-1.17	-2.83
STATE & LOCAL BENEFITS ($Billions)				
Personal Income Taxes	-.34	-.49-	.07	-1.53
Corporate Income Taxes	.13	.12	.11	.36
Indirect Business Taxes	-.37	-.52	-.73	-1.62
Total S&L Taxes	-.58	-.89	-1.32	-2.79
State & Local Net	-.69	-1.07	-1.46	-3.22

* Estimates prepared by Shriner-Midland Company

** Macroeconomic simulations by Chase Economics

The President's proposal would place a cap of $25 per person (including taxes and tips) on business marketing meals which could be deducted as a normal business expense. Amounts above the cap would be only 50 percent deductible; and the cap would be indexed for inflation, so the share of business meals affected would increase over time.

Based on a nation-wide survey of 55,000 households by NFO Research, approximately 18 percent of today's business marketing meal occasions, accounting for 43 percent total dollars spent nationally, exceed the proposed cap. With 4 percent inflation, the share of business meals affected by the cap would rise by 1988 to 25 percent of meal occasions, accounting for 54 percent of total dollars spent nationally. In major cities, where rent and other costs are higher and average restaurant tabs are correspondingly larger, the impact would be much greater. According to the latest national survey of business meal and lodging costs by the accounting firm of Laventhol & Horwath, the average cost of an evening meal at a typical sit-down restaurant is already above the proposed cap in 46 major U.S. cities. (See Table II).

The actual dollar value of business meal expenditures above the proposed cap would rise from about 17 percent today to about 22 percent in 1988 due just to inflation. When tax and tip are included along with inflation, the actual menu price of a business meal in 1988 would have to be less than $17.15 in today's prices to avoid the cap.

Reducing the deductibility of business meal costs above the cap to 50 percent will make business meals relatively more expensive than other marketing expenses that continue to be fully deductible. Since business meal purchases are extremely price sensitive, the result will be a sharp reduction in meal expenditures affected by the cap and a corresponding reduction in restaurant sales and employment. Studies prepared for Treasury's Office of Tax Analysis indicate that spending on business marketing meals declines by 2 to 4 percent for every 1 percent increase in their relative price. Reducing the deductibility of meals over the proposed cap to 50 percent is equivalent to an increase in their relative price of 24 percent. Hence, the proposed $25 per person cap would result in a drop of 50 to 85 percent in purchases of business meals above the cap price and in a drop in total business marketing meal purchases on the order of 9 to 15 nationally. The drop would be much greater in metropolitan areas, where the share of business meals above the cap is much larger.

The impacts of the proposed cap shown in Table 1 are based on the low-end estimate of a 9 percent reduction in business meal purchases nationally, compared with the level of business meal purchases that would occur under "Treasury II" without the business meals cap. During the first three year--1986-1988--direct losses in restaurant sales would total $11.8 billion and direct losses in restaurant employment would total nearly 460,000 person-years. The reduction in restaurant sales would produce a direct drop in state and local sales tax receipts of more than $700 million.

When indirect effects are taken into account, using the Chase Econometrics U.S. Macroeconomic Model, total U.S. employment would be reduced by 580,000 jobs during the first three years. Federal corporate taxes would rise about $5.4 billion during this period; but this increase would be more than offset by lower tax receipts from individual taxpayers and higher expenditures due to the increased unemployment created by the cap. Federal receipts from personal income taxes and social security taxes would fall by $2.2 billion and $2.4

billion, respectively, while transfer payments would rise by nearly $2.4 billion. As a result, the net financial position of the federal government would be decreased some $2.8 billion in the initial three year period if the cap is imposed.

The impact on state and local governments is even greater. Nationally, when indirect effects are taken into account, total state and local tax receipts would be reduced by $2.8 billion in the initial three year period. When higher expenses due to higher unemployment are factored in, the net financial position of state and local governments would be decreased by more than $3.2 billion.

Even though Treasury claims the business meals cap has only a "small revenue impact," the cap widens the federal deficit and substantially worsens the adverse impact of "Treasury II" on state and local governments. When the impacts on federal, state and local budgets are combined, the total during the initial three-year period is just over $6 billion.

LIST OF CITIES WHERE DINNER COST (Including Tax and Tip) IS ABOVE $25.00

CITY	DINNER	15% TIP	TAX	TOTAL
New York	$38.36	$5.75	$3.16	$47.27
Washington D.C.	28.28	4.24	1.70	34.22
Santa Barbara	26.57	3.98	1.73	32.28
Dallas	26.42	3.96	1.62	32.00
San Francisco	26.04	3.91	1.69	31.64
Chicago	26.03	3.90	1.56	31.49
Buffalo	25.50	3.82	2.04	31.36
Seattle	25.28	3.79	2.00	31.07
Houston	25.53	3.83	1.56	30.92
Newark	25.33	3.80	1.52	30.65
New Orleans	24.53	3.68	2.21	30.42
San Antonio	25.15	3.77	1.41	30.33
Nashville	24.88	3.73	1.37	29.98
Austin	24.57	3.68	1.26	29.51
Philadelphia	24.09	3.61	1.44	29.14
Columbus	24.08	3.61	1.44	29.13
Atlanta	24.20	3.63	1.21	29.04
Wilmington	24.29	3.64	1.09	29.02
Richmond	24.33	3.65	.97	28.95
Los Angeles	23.81	3.57	1.55	28.93
Minneapolis	23.81	3.57	1.43	28.81
Baltimore	23.91	3.59	1.19	28.69
Dayton	23.52	3.53	1.41	28.46
Denver	23.40	3.51	1.54	28.45
Rochester	23.16	3.47	1.62	28.25
Boston	23.42	3.51	1.17	28.10
Detroit	23.41	3.51	.94	27.86
San Jose	22.58	3.39	1.58	27.55
Miami	22.80	3.42	1.14	27.36
Cleveland	22.47	3.37	1.46	27.30
Hartford	22.20	3.33	1.66	27.19
Phoenix	22.63	3.39	1.13	27.15
Tulsa	22.33	3.35	1.34	27.02
Corpus Christi	22.40	3.36	1.15	26.91
Fort Lauderdale	22.33	3.35	1.12	26.80
Pittsburgh	21.75	3.26	1.30	26.31
Norfolk	22.08	3.31	.88	26.27
Baton Rouge	21.40	3.21	1.50	26.11
Lexington	21.67	3.25	1.08	26.00
Little Rock	21.65	3.25	1.08	25.98
Fort Wayne	21.61	3.24	1.08	25.93
Cincinnati	21.50	3.22	1.18	25.90
San Diego	21.36	3.20	1.28	25.84
St. Louis	21.06	3.16	1.26	25.48
Greensboro	21.32	3.20	.96	25.48
Indianapolis	21.05	3.16	1.05	25.26
Albany	20.70	3.10	1.45	25.25
Columbia, SC	21.00	3.15	1.05	25.20
Memphis	20.51	3.08	1.59	25.18
Albuquerque	20.90	3.13	.97	25.00

Notes: Average dinner cost at downtown hotels responding to Laventhol and Horwath Survey. Meal includes shrimp cocktail, prime rib and vegetables, ice cream and coffee. No alcoholic drinks are included.

Sources: Dinner cost, "Corporate Travel Index, 1985," Laventhol and Horwath. Local sales tax and tip computed by NRA.

In conclusion, Mr. Chairman, IFDA is here today not only to show support for our customers in the restaurant business, but to ask you to consider the total impact of these proposals on the entire foodservice industry. Consider the waiter, the cook, the bus boy in the restaurant, then consider the salesman, the delivery truck driver, and the warehouse worker at the foodservice distributor level, next consider the packer, the processor, and the junior executive at the factory. Consider they all face uncertainty about their jobs, think of their families. The effect of this legislation would cause unemployment in all these groups.

There is an old saying "if it's not broke, don't fix it" that holds true in this situation. The system is working and we have no need to change for the sake of change. The International Foodservice Distributors Association requests the Congress to delete this section of the President's proposal.

I would again like to thank the committee for this opportunity to testify on behalf of the International Foodservice Distributors Association.

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October 17, 1985

Via Federal Express

Ms. Betty Scott-Boom
Committee on Finance
219 Dirksen Senate Office Building
Washington, D.C. 20510

Re: Recognition of Gain on Pledges of Installment Obligations

Dear Ms. Scott-Boom:

I respectfully request that you consider the following written comments with respect to the proposed legislative changes concerning the tax treatment of pledges of installment obligations.

1. Effective Date and Fairness Issues.

I ask that your Committee not adopt the change in effective date proposed by the Staff of the Joint Committee on Taxation in their September 26 Summary of Tax Reform Options for Consideration by the Committee on Ways and Means (JCX-23-85).

The President's tax proposal to Congress, dated May 29, 1985, would generally treat the proceeds of a loan for which an installment obligation is pledged as a payment on the installment obligation. The proposal would be effective for installment obligations pledged as security on or after January 1, 1986.

The Staff of the Joint Committee proposed that installment debt created after September 25, 1985, would be considered pledged on January 1, 1986, if previously pledged for a note outstanding as of that date. The effect of that change would be to accelerate the effective date of the proposed provisions from January 1, 1986 to September 26, 1985, the date of the Staff's report.

In planning commercial affairs, taxpayers rely on rules currently in effect. Legislative changes are sometimes warranted even if, as a result, they frustrate transactions planned by taxpayers based on existing rules. However, moving an effective date provision to a date that has already passed is the kind of sudden and unwarranted change that strikes taxpayers as particularly unfair, especially where, as here, a change in effective date is proposed almost four months after the President's proposal and after hearings on the provision were held by the House Ways and Means Committee. Accordingly, I believe that if the proposal is enacted, it should be under the effective date as originally proposed.

2. Pledges of Installment Obligations Where the Taxpayer Remains at Risk.

It would be unfair to taxpayers to trigger installment gain in all instances in which an installment obligation is pledged as collateral for a debt. In many cases -- such as those in which other assets of the taxpayer or a related party are available to satisfy the debt -- the pledge of the installment obligation should be treated no differently than any other borrowing by the taxpayer.

For example, assume a taxpayer is an obligor on a fully recourse obligation of $100, as security for which he has pledged an installment note, even though he has at least $100 worth of other assets available to satisfy the recourse obligation. In such a situation, the taxpayer-borrower retains a significant commercial risk with respect to the borrowed amount on assets other than the note. Therefore, gain on the installment note should not be recognized. It would be inappropriate to penalize the taxpayer because the lender insists on the note as collateral. In many situations, the lender would have advanced the funds based on an overall credit evaluation of the taxpayer, but insists on a pledge of the installment obligations simply because it is easy to obtain a security interest in such an obligation. Similarly, gain should not be recognized where other assets are actually pledged as collateral, or where the debt is guaranteed by a related party who owns sufficient assets to satisfy such guaranty.

I suggest that the Committee except situations such as those described above from the proposed treatment of pledges of installment obligations.

I would be happy to speak with members of your Committee to clarify or expand upon the above comments and to assist in drafting the technical language. Thank you for your consideration.

Respectfully submitted,

Gerald Rokoff

GR/bd

M

COMMITTEE ON FINANCE, U.S. SENATE

TAX REFORM HEARINGS - METHODS OF ACCOUNTING

WRITTEN TESTIMONY OF MONTGOMERY WARD ON PROPOSAL TO RECOGNIZE GAIN ON PLEDGES OF INSTALLMENT OBLIGATIONS

BACKGROUND

Montgomery Ward & Co., Inc. is one of the nation's largest mass merchandisers. During 1984, it had sales of $6.5 billion and the equivalent of 78 thousand full-time employees. At year end, Montgomery Ward had 366 retail stores, 283 catalog locations and 1,509 catalog sales agencies in 49 states.

During 1984, Montgomery Ward credit sales were 56.4% of total sales, or $3.7 billion. At year end 1984, customer receivables were $4 billion. Montgomery Ward's customer receivables had an average maturity of 11.9 months in 1984. It should be noted that the average maturity of receivables varies with credit terms available. Ward, for example, has shortened its credit terms and the average maturity of its receivables has decreased as follows: 16.1 months in 1980, 14.9 in 1981, 13.2 in 1982, and 12 in 1983. For tax reporting purposes, Montgomery Ward uses the installment method of accounting for sales made under its revolving credit plan. Under the installment method, income tax is not due until the customer receivables are collected.

THE PRESIDENT'S PROPOSAL

Chapter 8.02 of the President's tax proposal, dealing with the recognition of gain on pledges of installment obligations, would adversely affect the way in which Montgomery Ward and many other retailers use this long-accepted method of accounting and could alter significantly the way it finances its business.

The proposal provides that taxpayers using the installment method of accounting should be treated as having collected their proceeds to the extent they have used an installment receivable to secure a borrowing, particularly if they no longer bear the risk that the receivable will become uncollectible. The proposal seeks to prevent abuses, such as the real estate transaction it cites, not to eliminate the installment method. Accordingly, the proposal provides exceptions for certain business transactions.

CONCERNS AND RECOMMENDATIONS

While we agree with the proposal's goal of curbing abuses, we have identified four areas of concern:

I. Under the proposal, there is an exception for a revolving credit plan which, by its terms and conditions, contemplates that all charges for each sale will be paid within one year from the date of purchase. Many retailers, however, base the payment terms of their revolving credit plans (i.e., the minimum amount which must be paid each month) on the type and mix of merchandise they sell. Customers generally require a longer period to pay for major purchases, such as appliances, than for less expensive items. Even if the terms and conditions of revolving credit plans allow for payments to stretch beyond twelve months, many customers pay in less time and the average period of repayment may be, as it is for Montgomery Ward, less than twelve months. In spite of the facts, however, the exception, would not apply to any installment receivables under these plans, including those which are paid off within twelve months. This is patently unfair. We understand that Treasury is aware of this problem and is working on a solution. One solution would make the exception apply to a revolving credit plan if the average maturity of the receivables under the plan is 12 months or less or if annual collections of receivables exceed total receivables at the beginning of the year. While a 12-month rule would satisfy Montgomery Ward, other retailers may have a longer average maturity because they sell a greater percentage of appliances. We suggest an 18-month rule would be appropriate so that the tax law does not favor merchants which sell primarily apparel over those which sell primarily appliances.

II. The proposal also contains an exception for indebtedness owed to a financial institution and secured by a general lien on all of the borrower's assets.

The proposal provides that the general lien exception will not apply if the installment obligations are transferred to a financing subsidiary which has few assets other than tax deferred installment obligations. However, it is not clear that another exception, such as the twelve-month exception, would apply to a finance subsidiary. It should be clarified that only the general lien exception, but not the other exceptions, is inapplicable to a financing subsidiary.

Moreover, the general lien exception applies only to indebtedness owed to a financial institution. We see no reason, tax or otherwise, why the exception should not apply to indebtedness owed to entities or persons who are not financial institutions. Thus, the reference to financial institutions should be deleted.

III. A third exception is for indebtedness which, by its terms, requires payment in full within a period not exceeding 90 days from issue and which is not renewed or continued.

A question may arise under the proposal as to whether an indebtedness is considered renewed or continued and, thus, not excepted if a creditor acquires indebtedness of the debtor on a continuing and ongoing basis but without any obligation or preexisting arrangement with the debtor to do so. For example, Montgomery Ward may issue commercial paper #1 to X on August 1 and redeem the paper on September 30. It may also issue commercial paper #2 to X on September 30 and redeem it on November 30. The two issues are unrelated and X has no preexisting obligation to take issue #2.

It should be made clear that issuing new indebtedness to a prior creditor does not constitute a renewal or continuation of the old indebtedness so long as there is no preexisting commitment for the creditor to acquire the new indebtedness.

IV. The proposal provides a five-year transition rule for installment obligations pledged before January 1, 1986 and any debt which was secured by a pledge before January 1, 1986. It should be made clear that a rollover of receivables which are pledged will not be treated as a new pledge after January 1, 1986 or the transition period would be eliminated.

We will be happy to supply any information that may be useful to the Committee, or to work with the staff to solve any technical problems that may arise.

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STATEMENT OF THE NATIONAL AUTOMATIC MERCHANDISING ASSOCIATION IN OPPOSITION TO THE PRESIDENT'S PROPOSALS ON DEDUCTIBILITY OF ENTERTAINMENT EXPENSE AND BUSINESS MEALS

By

G. Richard Schreiber, President

To: The Members of
House Ways and Means Committee
Senate Finance Committee

July 26, 1985

The National Automatic Merchandising Association (N A M A), founded in 1936, is the national trade association of the merchandise vending and contract foodservice management business. Its membership, totaling 2,400 companies, includes service companies, vending machine manufacturers and suppliers of vendable products.

Overall, N A M A membership consists of a large number of small to medium size companies as well as a few large corporations which are either publicly held or subsidiaries of conglomerates.

The Board of Directors of N A M A has asked me, as the chief executive officer, to express certain concerns of our members about the proposed tax reform legislation submitted to Congress by the President.

The general consensus of our members is to commend the President and congressional leaders for their serious consideration of a program to reform and simplify the Federal Income Tax Code. Lower tax rates would be an advantage to the members of N A M A, and they understand that to provide for lower rates it will be necessary that other changes in the tax code be made to preserve "revenue neutrality."

A small percentage of N A M A's member companies operate public restaurants and a similar small percentage have concession divisions providing food and beverage service at sports stadiums, auditoriums and similar places of public entertainment.

Our members who operate public restaurants and those who offer concession services support the views previously submitted to the Congress and the Administration by trade associations representing those industries and by individual companies within those industries.

They are opposed to the President's proposal to eliminate the entertainment expense deduction and place a cap of $25 per person on deductions for business meals with a 50% reduction on amounts over $25. The restaurant and public entertainment industries cite the negative effect of these proposals on business volume thus reducing growth and employment opportunities which in turn would have an adverse effect on the suppliers to these businesses. The loss of taxes on reduced income could offset any revenue increase produced by these proposals.

In addition, on behalf of the entire N A M A membership, I want to share their concern from a general business point of view over the proposed elimination of the entertainment expense deduction and the cap on the business meal expense deduction.

The nature of the vending and foodservice management business is such that we are not in a position to effectively advertise, for example. As a result, our companies have used business entertainment and the business meal as major marketing tools to secure and retain clients. The two proposals would force our members to direct the promotional dollars away from the business meal and entertainment expense to other, less effective forms of promotional activity which would remain fully deductible under the President's plan. Because the nature of the vending and contract foodservice management business involves one-on-one marketing, we would be put to a disadvantage compared to other businesses which can avail themselves of a much wider range of tax-deductible marketing activities.

The cap on the business meal deduction would also complicate what is now a very simple method of conducting and promoting business. It would add a layer of unnecessary record keeping to a tax system supposedly being simplified.

Purely apart from that argument, another issue is whether a $25 limit on the business meal deduction is appropriate and fair throughout the country. The government itself has long recognized differences in the costs of meals and lodgings in different cities.

Conclusion

For the reasons stated above, N A M A members join with many others in the business community in opposition to the purposed cap on business meals and the elimination of the entertainment expense deduction. We hope that the members of Congress will share our view on this vital issue and reject any proposal to limit or eliminate these two important business expense deductions.

Respectfully submitted,

G. Richard Schreiber
President

Statement

by the

National Coalition on Banquets and Conventions

Suite 200
2000 L Street, N.W.
Washington, D.C. 20036

Senate Finance Committee

October 18, 1985

The National Coalition on Banquets and Conventions submits this statement for consideration by the Senate Finance Committee in connection with its hearings on tax reform.[1/]

We believe that, in connection with its consideration of the question of the deductibility of business meals, the Committee should be aware of the unique characteristics of officially sponsored banquets and receptions -- they are an integral part of a business program -- and of the costs that are ordinarily incurred in connection with such events. Further, we believe that the Committee should be aware of the impact that enactment of the proposal would have on the banquet and reception industry and on employment in that industry.

We also believe that, in considering the deductibility of business travel expenses, the Committee should be aware of the

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1/ A list of the members of the Coalition is attached.

importance and nature of business conventions, and the effect that a cap on the deductibility of business travel expenses would have on the convention industry and on employment in that industry.

We are submitting this statement in order to draw the Committee's attention to these issues.

The Administration's Proposals Relating to Business Meals

The President's Tax Proposals to the Congress for Fairness, Growth and Simplicity (the "Plan") would limit deductions for ordinary and necessary business meals to $25 for each participant in the meal, plus 50 percent of the expenditures in excess of that amount. In addition, the Plan would allow such deductions to be taken only if the meal takes place in a "clear business setting", as that term is defined under present law.2/

The proposal is aimed at disallowing that portion of the cost of a business meal that is likely incurred for personal, rather than business, benefit. Recognizing the "difficulty of identifying the business component of expenses that have obvious personal benefits and are commonly incurred in nonbusiness contexts," the Administration proposes a "relatively mechanical

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2/ Treas. Reg. § 1.274-2(c)(4) provides that "entertainment shall not be considered to have occurred in a clear business setting unless the taxpayer clearly establishes that any recipient of the entertainment would have reasonably known that the taxpayer had no significant motive, in incurring the expenditure, other than directly furthering his trade or business."

limitation on the deductibility of business meals, targeted at meal expenses that are most likely to provide a significant level of personal consumption." Unfortunately, no differentiation is made by the Plan among different types of business meals.

Business Banquets and Receptions Are Not Abusive

The Plan fails to recognize that business banquets and receptions do not present a potential for abuse. The Administration seeks to limit the deductibility of expenses that represent the satisfaction of "personal entertainment desires." Application of the $25 limitation to banquets and receptions, however, would do nothing to further this goal. Expenses incurred in connection with business banquets and receptions are prime examples of expenses directly related to the taxpayer's business. Such banquets and receptions generally provide for speakers or discussions on topics of interest to the business or profession. The clear focal point of the banquet or reception is the speaker or presentation to be made, and the likelihood that discussions will center on business is great. Further, there is rarely any personal choice available to the participants in a business banquet or reception. The food and beverages to be offered, and the setting in which the meal is to be provided, are chosen by the organizer of the event, not the participant. That the attendees of such an event should be able to enjoy a meal while they remain intent on the business at hand hardly seems cause for Congressional concern.

Enactment of the Administration's Plan Would Have a Devastating Impact on the Banquet Industry

The Administration's description of its proposal asserts that the $25 allowance proposed by the Plan "will not have a significant impact on more than five percent of restaurants," in that it is well in excess of the average cost of a restaurant meal. However, the Plan fails to recognize that not all business meals are restaurant meals. Rather, many business meals that could be subject to the new rule are provided in connection with banquets or receptions for meetings of business or professional associations or for sales, product or trade shows; and, as discussed more fully below, such meals are considerably more expensive than restaurant meals. Thus, the proposal would have a significant impact on the banquet industry, especially in light of the fact that more than two-thirds of all banquets and receptions are provided for business purposes.

For a variety of reasons, the average per participant cost of a banquet or reception is significantly greater than the average per participant cost of a restaurant meal. Indeed, the average cost of a banquet dinner is more than $25 per participant. This is attributable to the fact that, whereas food and beverage costs account for a substantial part of the average restaurant bill, the total cost of a banquet or reception includes substantial expenses attributable to additional personnel, overhead and other factors. For example, the cost of a banquet includes the expense of setting up the tables and decorations before the meal, as well as taking them down afterwards. Further, the cost of a banquet or reception reflects the use of the room for an entire evening, whereas the cost of a restaurant meal reflects the use of a dining table for only an hour or two, since a restaurant will seat customers at any particular table continuously throughout the course of an evening.

Enactment of the Administration's Plan Would Substantially Reduce Employment in the Banquet Industry

We wish to emphasize one final important point. Because more than two-thirds of the banquets and receptions held each year are business banquets and receptions, application of the proposal to banquets and receptions would have a dramatic impact on employment in the banquet industry. The Treasury Department's Office of Tax Analysis has indicated that every one percent increase in the price of business meals results in a two to four percent decrease in the demand for such meals. Chase Econometrics, a prominent economic forecasting firm, has concluded in a study conducted for the National Restaurant Association that the Administration's proposal to limit the deductibility of business meals would cause a decline in demand that would lead to the loss of some 580,000 jobs. Many of these jobs will come from the banquet industry. In this regard, it is important to recognize that the banquet industry relies heavily on the employment of unskilled, entry-level workers. These employees would be left with few employment options if the proposal were enacted.

This loss of jobs will also severely affect the communities in which banquet and reception facilities are located. It has been estimated by the MainStreets Coalition, a broad-based group concerned about the impact of tax reform on the urban economy, that state and local governments across the country will lose $3.2 billion over the next three years as a result of the decline in employment discussed above. Moreover, especially in some rural areas, banquet and reception facilities are major employers and sources of revenue for the entire community. Limitations placed on the deductibility of expenses incurred for business functions held in such facilities could have a devastating impact on these communities.

Further, enforcement of the proposal would entail administrative costs and recordkeeping burdens that would outweigh by far the negligible revenue gain the proposal may be expected to produce.

In sum, although the proposal will drastically affect the American economy, it will produce no measurable benefit to either the government or the taxpayers.

The Staff's Proposal Relating to Convention Expenses

The staffs of the Joint Committee on Taxation and the Ways and Means Committee have proposed an alternative to the President's Plan (the "Staff Option"). Under the Staff Option, a taxpayer attending a business convention or seminar would be permitted to deduct his expenses only to the extent of 200 percent of the applicable Federal per diem reimbursement rate. This proposal raises a number of concerns that we would like to bring to the Committee's attention.

Business conventions play an important role in the American economy. Sales, product and trade shows are the most efficient way for an employer to educate its employees about a new product or technique, or for employers in an industry to learn about one another's operations. Further, professional conventions and seminars are an important means by which a profession maintains its standards and ensures its members' competence. Indeed, the benefit derived by American business from the free exchange of ideas at such seminars and conventions is essential to the proper functioning of our economy. It is in the interest of neither the government nor the public to discourage such events. The Staff Option, however, would in fact discourage the sponsorship of and attendance at business conventions and seminars. A limit on the deductibility of expenditures for meals and lodging while attending conventions will effectively increase the cost of attending a convention or seminar and severely curtail the ability of the average taxpayer to participate in such important business programs. It has been estimated by Hospitality Valuation Services, a leading analyst of hotels and convention hotels, that the effective cost increase that would be brought about by enactment of the Staff Option would "have a substantial negative impact upon convention attendance and the convention industry."

The simple fact is that the proposed cap is just too low. It does not reflect the real cost of attending a business convention or seminar. It does not, for example, take into account the fact that the average cost of a room in a convention hotel is now significantly higher than that of a hotel room generally. In New York City, where the Federal per diem rate is $75, a limit of only $150 would be imposed; but the average cost of a room in a convention hotel in New York City exceeds $150. Thus, under the Staff Option, taxpayers attending conventions might well be unable to fully deduct their hotel expenses, let alone the cost of any of their meals or other expenses. It is important to keep in mind that the cost of attendance must reflect the cost of the facilities and services that are provided. The cost of providing convention facilities is great. A convention hotel must make substantial capital expenditures in order to construct the meeting rooms, halls and other facilities required to accommodate a large number of people. In addition, providing convention facilities requires the hotel to hire a substantial number of additional personnel.

Imposition of a cap on the deductibility of convention or seminar expenses would devastate the convention and seminar industry. In 1984, the convention business accounted for $21 billion in revenues in the United States. 500,000 people are employed in this industry in New York City, Chicago and Atlanta alone. The loss of business brought about by enactment of the Staff Option would result in the loss of numerous jobs in this industry. We do not believe that this should be a goal, or even a by-product, of tax reform.

Finally, by limiting deduction of the cost of attending a business convention, clearly a legitimate business expense, the Staff Option unfairly singles out the hotel and restaurant industries. Expenditures for legal services, office expenses, and the many other varieties of legitimate business expenditures will continue to be deductible in full. There is no logical reason to treat legitimate business expenditures for meals and lodging any differently. Nonetheless, the Staff Option proposes to do just that.

Finally, enactment of the Staff Option would have an enormous effect on the industry and the economy. Since, as discussed above, convention attendance depends on the deductibility of convention expenses, the Staff Option in effect imposes a ceiling on convention prices that fails to reflect convention costs. Thus, if the Staff Option is enacted, hotels and related establishments will have no choice but to abandon a large part of their business. Since the convention business is an important part of the American economy -- some 37 million people attended trade shows in 1984, for example, spending an average of $250 per day -- the Staff Option will severely affect employment and local government revenues in the communities where convention facilities are located. This, too, should be neither a goal nor a by-product of tax reform.

In light of the foregoing, we strongly urge the Committee to reject the proposal contained in the Staff Option, or any similar proposal to limit the deductibility of convention expenses.

Membership

(In Formation)

National Coalition on Banquets and Conventions

American Society of Travel Agents
Holiday Corporation (Holiday Inns)
Hyatt Corporation
Lincoln Hotel Corporation
Marriott Corporation
Ridgewell's
Trammell Crow Properties (Wyndham Hotels)
Walt Disney World Corporation

STATEMENT

ON

TREASURY II TAX PROPOSALS

AND

THE DEDUCTIBLITY OF BUSINESS MARKETING MEALS

AND

THE USE OF THE CASH METHOD OF ACCOUNTING

To
Senate Finance Committee
October 18, 1985

By

Charles F. Haywood
President and Chief Executive Officer
NATIONAL FOOD BROKERS ASSOCIATION
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Mr. Chairman and Members of the Committee, my name is Charles F. Haywood, President of the National Food Brokers Association, located here in Washington, D.C. I appreciate this opportunity to express to you the views of NFBA and its members on The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity.

NFBA is a national trade association representing approximately 2,400 food broker companies, employing approximately 60 thousand employees, nationwide and overseas. All food broker companies can be classified as small businesses and most are privately owned. The entire food broker industry accounts for the majoirty of total food sales in the United States, which amounted to well over $400 billion in 1984.

Food brokers serve as independent sales representatives for manufacturers and processors of food and nonfood grocery products sold to wholesale, retail and various foodservice outlets. A single food broker may represent an average of 35 manufacturers selling products to customers in their market area. Food brokers are also the most cost-effective sales network available to a manufacturer in the distribution of its products, as they are able to represent many seller's products at one time using their expert knowledge of the market which they service.

The success and growth of the food broker profession in the United States is a direct result of being able to sell more merchandise at less cost. Food brokers are the most efficient method available to get the products from the manufacturer to the buyer. The food broker industry is a vital and intregal segment of the vast food distribution system in the United States. Their necessity has increased significantly as they contribute greatly to the low cost of food and grocery products in this country.

NFBA wants to express to you its strong support for tax reform legislation. The focus of our support rests mainly on corporate rate reduction and a fairer graduated rate structure for small business.

Liberal and Conservative lawmakers tend to disagree on many things, but the one thing they both agree on is the need to reform the nation's tax system. It appears that the majority of American individuals and businesses support President Reagan and Congressman Rostenkowski in their campaign for tax reform.

Tax reform is not a new concept. The idea that our tax code is in need of a major overhaul has been gaining momentum and support over the past few years. This country has recently experienced a period of economic growth and prosperity. People feel the time has come to install a new tax system that will further promote economic growth and prosperity for everybody.

There is no better time than now to reform the nation's tax code. Congressmen, business leaders and individuals have all come to the conclusion that the present tax code is greatly unfair, grossly complex, prevents economic growth and encourages abuses and noncompliance.

The food and grocery products industry, in which food brokers play an major role, is labor intensive and therefore is among the highest effective rate taxpayers in industry, according to the most recent study by the Joint Committee on Taxation. The present tax code is clearly unfair when it requires a food broker to pay up to one-third of his business income in taxes, while many large, profitable, growth corporations are paying little or next to nothing in taxes because of the numerous deductions and credits they are able to utilize under the present tax code. A tax code that allows one industry to subsidize the taxes for another is unjust and unfair and needs reformed.

Our tax system is clearly inequitable when it forces a small businessperson, such as a food broker, to pay a heavy percentage of his earnings to the government, while the government is paying millions of dollars in rebates back to large corporations with profits in the million and billions of dollars.

Small business is the economic backbone of America. According to recent polls, small business created more jobs in the last three years than big business. Our nation's tax code should complement the growth of small business, the creator of new jobs, not hinder it. Any new tax bill that Congress decides to write should not favor big business over small business, nor should it give preferential treatment to one industry over another.

In 1962, President Kennedy proposed tax credits hoping to solve some of the problems facing America's stuggling steel industry. Since then, the tax code has been adjusted and tampered with to try to solve the economic woes of certain classes of industries that were having difficulties. Today, even with all of the special tax credits and incentives, America's steel industry is worse off than it was twenty years ago. This is living proof that our present tax system has failed to create economic growth for industries it was intended to help.

Meanwhile, while certain industries continue to suffer, other large, profitable, growth industries have found it wise to divert their energies to figuring out how to best take advantage of the tax breaks that were meant for others. Industries that are not ailing but take advantage of the numerous tax loopholes are contributing to the abuse of the tax system. While the Treasury continues to lose billions of dollars every year in unpaid tax revenues, Congress has created a complex tax code that makes these abuses all perfectly legal.

Small businesses in the food industry are at an even greater disadvantage than their big business counterparts. Small food broker companies do not have the large amounts of capital or the cash flow that large corporations have needed to purchase tax shelters. The tax code as it exists today encourages large, labor-intensive businesses to misdirect financial and human resources towards other unrelated businesses in order to shelter their money. There is a built-in bias in the present tax code as it offers certain advantages to large companies that small companies are unable to use.

Not only does our tax system favor big business over small, but it encourages time, money and resources to be spent by corporations on tax planning when they should be spent on economic growth, investment and the creation of new jobs.

It is dramatically evident that tax preferences for some create higher tax rates for all of us. High tax rates stifle economic growth, especially for small businesses, and they discourage the entrepreneurial spirit that has made this country great. Although NFBA feels that Congress should take a closer look at the equity of the proposed graduated rates for small business, we believe that the proposed lower corporate tax rates and fairer graduated rates for small business will encourage economic growth for American business, both large and small, and for our country.

NFBA believes that tax reform is needed so that the food broker industry can grow and prosper at a more equal rate. The growth rate of the tax-avoiding industries has far surpassed that of the food industry as a result of the many complex tax preferences in the tax code. NFBA supports a more equitable tax code, for both individuals and corporations. We believe that this will be healthy for American business and for the country as a whole.

NFBA supports most of the President's tax reform plan. We believe that many of the proposals are justified and long overdue. NFBA objects, however, to two specific proposals.

Our first objection is to the proposal that calls for a limit on the deductibility of the business marketing meal and a total elimination of the deductibility of business entertainment expenses.

NFBA represents a significant number of food brokers who are heavily or totally involved in the foodservice business. We believe that an arbitrary cap or any type of limitation on the deductibility of the business marketing meal and a complete elimination of the deductibility of business entertainment expenses will have a definite and far-reaching adverse effect on the entire foodservice industry.

This legislative idea is not a new one. The business marketing meal deduction over the years has been dubbed the "three martini lunch." This lable is a misnomer and misrepresents a legitimate business expense that fosters economic growth and employment. In this day and age of highly professional and competitive business activity, a literal "three martini lunch" would be imprudent for any businessperson who is trying to convey a professional image or maintain a competitive position in the marketplace.

It is indeed the bad public perception that the "three martini lunch" lable has created for a legitimate marketing tool that has brought the issue of the deductibility of the business marketing meal before this committee time and time again. So far, the committee members have not been swayed by the bad publicity, but rather have realized the negative consequences of the elements of such tax proposals.

NFBA would like to emphasize that the deductiblity of the business marketing meal for years has been recognized as a legitimate marketing expense. Other sales-generating expenditures, such as advertising, promotions and free samples, are all fully deductible and, like the business marketing meal, are intregal parts of marketing strategies for many businesses. NFBA believes that the business marketing meal should not be singled out for such limitations, as no other area of business expenditures is subject to such an arbitrary spending ceiling.

In addition, many businesses produce goods and services that are not designed for the mass market and cannot effectively use the mass media to promote their wares or services. These types of businesses, particularly service businesses, rely heavily, if not totally, on the use of the business meal as a markting device. If a large corporate manufacturer is able to fully deduct the costs for advertising and promotions that are designed to market a particular product, then a small business should be able to fully deduct the cost of a business meal that is designed to market a particular service.

A restaurant and other eating places offer the businessperson the type of relaxed, personal environment away from the office which is often times crucial for putting together business deals. Most businesspersons know the importance of doing business outside the office, whereas nonbusinesspersons lack the insight and the experience to see the value of this important marketing strategy. Often times, the business meal is the only means by which one businessperson is able to attract another businessperson to meet in a neutral environment.

The other proposal in the President's tax plan that NFBA strongly objects to is the one which would limit the use of the cash method of accounting. More specifically, the proposal would require all companies to use the accrual accounting method if their gross annual receipts exceed $5 million and companies below this amount if they use an accounting method other than cash in its financial statements or other reports to owners or creditors.

Approximately 75 to 80 percent of all NFBA member companies operate their businesses using cash accounting. The food broker industry is a service industry, and like many other service industries, most food brokers find the cash method the best suited for the nature of their business.

NFBA does not view the President's proposal that will limit the use of the cash accounting method as one creating fairness, growth or simplicity.

Food brokers use the cash accounting method based on the principle that they should be required to pay tax only when income has been received. Inherent in the substance of the Internal Revenue Code is the concept that tax liability should be based on the ability to pay. The cash accounting method does accurately reflect income, contrary to what the Treasury Department thinks, because it is directly related to the receipt of cash. It would be unfair to tax a business for work that has been done but for which no payment has been received. Often times complications arise where significant amounts of accounts receivable are never billed or collected.

The food broker business is frequently viewed as risky because food brokers operate on 30 day contracts with the manufacturers. At any time during this 30 day period, a manufacturer can cancell a contract with the broker. This system of doing business always leaves uncertainty about the duration of a manufacturer-broker relationship and creates a constant feeling of uneasiness for the broker.

The cash accounting method is highly valued by most food brokers because it allows them to pay tax only when payment is received from the manufacturer. This helps to alleviate some of the uncertainty and uneasiness that is common in the food brokerage business.

On the average, a food broker waits two to three months before he receives payment for his services from the manufacturer. In some cases, if merchandise is damaged or the manufacturer has trouble making a payment, which in not rare, the time between the date of sale to the date of payment received can be up to six months or more. In other cases, a manufacturer may cancell a contract or go out of business and the food broker may never see a payment for the work he performed.

The cash accounting method allows the food broker to take these risky situations into account and does not require him to pay taxes on income that is late or on income that he will never receive. If a food broker is forced to pay taxes on money he does not have, he will be forced to keep more funds tied up in savings to pay taxes rather than use the funds for expansion and promotion.

The cash method allows the food broker to act knowing that he will not have a dangerous cash flow problem or have to borrow additional funds if he cannot meet his expenses. This seems to be reasonable justification for operating a food brokerage business on the cash accounting method.

The application of the proposed limitation of the cash accounting method would also be unfair because it would allow those service businesses currently using the cash method for reporting taxes to continue to do so if they do not meet the criteria for change. Those taxpayers retaining use of the cash method would thus have a built-in competitive edge over their competition. This could be particularly damaging to a smaller food broker.

Furthermore, for 75 years the cash method of accounting has been recognized as the least complicated way to compute taxable income. It was not adopted and designed as a loophole, tax incentive or a device for abuse. The vast majority of service businesses keep their records, pay their bills and compute their taxes based on this method. If Congress includes this proposal in any tax reform bill, it will be taking one more right and one more freedom away from the American taxpayer.

The success of the food broker rests on the fact that he can do a more efficient job in his market than a direct sales force at a lower cost to the manufacturer. One of the greatest attributes of a food broker is his ability to run a very efficient, stream-lined business. This enables the food broker to keep costs down for him, for the manufacturer and ultimately for the consumer. The cash accounting method is one element of the food brokerage business that allows the food broker to control his costs.

The most compelling argument against the proposed limitation on the use of the cash accounting method is that it would have an overall negative impact on economic growth. If service businesses are restricted from using the cash method, it may cause cash flow problems and may require them to borrow money to meet the tax burden on income that has not yet been received. This could very well happen in instances where a firm's money is tied up in mortgage payments, car payments, new offices equipment payments, bonuses and retirement plan contributions and various other investments and expenses. The hardest hit service businesses in this situation would be the smaller businesses that need capital to grow and businesses that are just emerging that need capital to get started.

In addition, as a client's business grows and his accounts receivable increase, he would pay more tax on the uncollected receivables and not have those funds available for expansion and promotion. Futhermore, under the accrual method a client is not allowed to accrue bonuses for officers and significant shareholders. Rather, these bonuses must be paid before year-end which causes a cash drain in the last fiscal month, and then it takes two to three months to recover the cash shortage just when taxes are due.

Many service businesses that currently use the cash accounting method are part of the most dynamic sector of the economy. Small business, let me reiterate, is the most important source of new jobs and economic growth in America. Requiring smaller service providers to abandon the cash accounting method clearly would be burdensome and would create problems for an important growth sector of the nation's economy.

The cash method for determination of taxable income is as old as the Tax Code itself. The proposal to limit its use is unecessary and does not fall in line with President Reagan's tax proposals for fairness, growth and simplicity. On the contrary, it just takes one more right and one more freedom away from the American taxpayer. Food brokers are strong advocates for tax reform on these principles, but this proposal satisfies neither of them.

The nation's tax system since the beginning has rested on faith. Americans have always had more faith in our tax system and the rate of noncompliance has always been viewed as relatively low compared to most other countries. However, over the years Americans appear to be losing the faith that has always been characteristic of them as loyal taxpaying citizens. Last year alone, it was reported that the Treasury failed to receive over $200 billion in uncollected tax revenues. This is enough evidence to show that the American taxpayer is losing faith in the tax system.

Tax reform is badly needed to restore the faith of the American taxpayer, which has always been the foundation for success upon which our great nation has rested for many years. Any tax reform bill that Congress writes should treat individuals and businesses equally. A new tax code should be fair, equitable, relatively simple, promote economic growth and restore faith. Tax reform is the answer for renewed faith and a stronger, healthier America.

WRITTEN STATEMENT OF ROBERT NEDERLANDER, PRESIDENT OF NEDERLANDER PRODUCING COMPANY OF AMERICA, INC. BEFORE THE SENATE FINANCE COMMITTEE HEARING ON BUSINESS ENTERTAINMENT DEDUCTIONS

Held

October 4, 1985

My name is Robert Nederlander. I am President of Nederlander Producing Company of America, Inc., one of the largest owners and operators of legitimate and concert theatres in the United States. I am proud to be part of an industry which has played such a vital role in our nation's history.

In this business, I am fortunate to have come in contact with many other owners, operators, producers and performers in the industry, both large and small. Although I am submitting my testimony on behalf of our organization, I believe that this testimony represents the concerns of profit and non-profit theatre owners, operators, producers and performers all over the country, regarding the President's tax reform proposal.

I am deeply troubled by the President's recommendation to eliminate the deduction for business entertainment expenses. I am equally disturbed by the alternative recently presented by staff to the House Ways and Means Committee which would limit this deduction to 50 percent. Neither proposal would produce a substantial revenue gain, but both proposals reflect a hostile attitude toward business expenses and toward the arts, neither of which is warranted. They ignore the net loss in tax revenues which would result as theatres are forced to close. Although cloaked in the mantel of tax reform, these proposals, in tandem with other Administration positions, will seriously erode the viability of the performing arts in America.

ELIMINATING THE ENTERTAINMENT EXPENSE DEDUCTION IS NOT TAX REFORM

More than twenty years ago, Congress acted to eliminate abuses in the deduction of business entertainment, meals and travel expenses by enacting Section 274 of the Code. Section 274 requires that in order to take the entertainment deduction, a taxpayer must establish "that the item was directly related to, or in the case of an item directly preceding or following a substantial and bona fide business disussion. . ., that such item was associated with, the active conduct of the taxpayer's trade or business." Treasury Regulations under Section 274 provide additional, extensive rules on what is deductible.

In contrast to the conclusory rhetoric of the President's proposal, Section 274 represents a reasoned determination that business entertainment can be a legitimate cost of producing taxable income. Such expenses represent a marketing tool--a form of advertising or method for promoting a firm while negotiations and discussions are in process with business clients. In contrast, the tax reform proposals do not recommend that other forms of advertising or marketing costs be limited. Nor do the proposals provide that only a fixed dollar amount or percentage of rent for office space, no matter how luxurious, will be deductible. To the extent abuses in the entertainment expense deduction may occur, the IRS already has at its disposal the necessary tools to rectify the problem.

Perhaps the clearest indicator that tax reform should not and need not include elimination of legitimate business entertainment deductions is that the two precursor tax reform proposals--Bradley-Gephart (S.409, H.R. 800) and Kemp-Kasten (S. 1006, H.R. 2222)--do not include this proposal. These well-respected alternative tax reforms efforts provided the impetus for the President's proposal. Those dedicated advocates of tax reform that drafted and support these proposals recognize, as should you, that tax reform does not require elimination of the business entertainment deduction.

In summary, while Section 274 recognizes that many entertainment expenses should not be deductible, it stands for the proposition that not all entertainment expense deductions are abusive. Instead, these expenses are part of modern day business practices and are no different than, for example, advertising or purchases of office furniture. Entertainment expenses should not be equated with abuses which cry out for tax reform.

THE THEATRE INDUSTRY PROVIDES TAX REVENUE AND INTER-CITY REVITALIZATION

The ticket deduction debates overlook the fact that this would be a net revenue loser based on the economics of the theatre industry. Many theatrehouses have served as a vital source of downtown revitalization. More jobs and clearly more tax revenues than would ever be collected from this tax proposal are generated under current law, as theatrical performances encourage viewers to travel downtown and patronize restaurants, bars, and hotels. Accordingly, businesses have developed around theatrehouses, bringing in tax dollars both to the federal government and to the locality.

Entry-level jobs have also been created requiring few special skills. Taxi drivers, dish washers, ticket clerks, and waiters have been hired by businesses growing up around theatre districts. If the loss of business ticket purchases forces these theatres to close, I sincerely believe that downtown customers no longer will have this strong incentive to frequent these establishments. It is easy to predict that the nearby restaurants and other similar businesses will be forced to close along with the theatre. In this era of high unemployment figures, the Congress would be shortsighted to let this happen.

DEPRESSED THEATRE INDUSTRY CANNOT SUSTAIN LOSS IN TICKET SALES

The proposal to eliminate the business entertainment expense deduction will reduce the gross revenues of performing arts organizations at a time when the theatre industry cannot sustain a substantial loss in revenues resulting from this proposal. You have, no doubt, been presented with a string of statistics highlighting the economic problems our industry is facing. However, I believe that a few bear repeating. The statistics on New York commercial theatre are the most comprehensive, and based on my experience nationwide, are indicative of theatres elsewhere. Since 1980, New York commercial theatre experienced a 48 percent decrease in new productions on Broadway, a 150 percent increase in costs, an only 64 percent increase in ticket prices, leading to a 33 percent decline in attendance.[1] Even non-profit theatres are affected. At least 30 major non-profit theatres have closed since 1980 due to the loss of financial support and more than two-thirds of all non-profit performing arts companies operated in the red for 1983-1984.[2] These figures clearly indicate that this is not a "glamour" industry requiring cuts in assistance. In fact, it indicates the opposite.

There would be no substitute for the lost business revenues if this proposal were enacted. The business sector currently is providing the necessary infusion of funds to keep the theatre industry alive. Depending on the locality, we estimate that about 20-35 percent of all gross revenues to theatrical productions is generated by the sale of tickets to the business sector. The President has expressed no interest in providing further direct assistance to the theatre industry. Instead, he has recommended that there be a 11.7 percent cut in the National Endowment for the Arts' 1986 budget. Increasing ticket prices is no substitute because we would lose too many theatregoers. In short, without continued support through at least the current level of business ticket purchases, many established and respected theatres will become permanently dark.

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[1] Source: League of American Theatres and Producers

[2] Source: Opera America Theatre Communications Group, American Orchestra Symphony Legaue, Dance U.S.A.

ELIMINATING THE DEDUCTION EXACERBATES THE GOVERNMENT'S NON-SUPPORT OF PERFORMING ARTS

The performing arts are an integral part of a civilized society. Yet the U.S. government, already lagging behind other countries in directly supporting local performing arts productions, has been further reducing its support in the last few years. Currently it provides only about two percent of income for all non-profit theatres. Attached is a chart recently published by the National Endowment for the Arts which highlights the disparity in government assistance between the U.S. and other countries.* The report analyzed theatres in the U.S., Canada and six European nations. Government support, for the select theatres analyzed in this report, ranges from 90 percent of income by France to less than ten percent by the U.S. Most European countries included in this study provide over 75 percent of select theatre revenues analyzed.

The National Endowment report, which covers Canada and six European nations, also highlights the importance of the tax code in ensuring private U.S. support for the arts where direct support is not provided:

> It is widely believed that an important, if not the most important factor in encouraging private support is the "friendliness" of the tax code.

Id. The report concludes that "[i]n the United States tax expenditures are a significant source of indirect aid to the arts." Id. at 55. Since the federal government no longer considers it prudent to directly fund the arts, it should not further eliminate the one documented vital source of private funds now available through the tax code.

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* J. Mark Davison Schuster, Supporting the Arts: An International Comparative Study (National Endowment for the Arts 1985).

SUMMARY

In simple terms, the tax proposal to eliminate or reduce business entertainment deductions is a net revenue loser. You must consider that the benefits of a viable theatre industry are felt all over the country as cities are able to revitalize around theatre facilities, creating jobs and additional tax revenues. Any small revenue gain resulting from the business entertainment proposal is no trade-off for a disastrous decline in the U.S. theatre industry.

Further, general tax reform principles clearly do not mandate this proposal. Entertainment expenses are as valid a deduction as any other expense incurred by a business to make money. A principal tenet of our income tax system is that taxable income does not include legitimate expenses incurred to produce that income.

Even if the revenues of this proposal are needed to reduce the federal deficit, this is not the place to find them. The theatre industry, in particular, has been hard hit by inflationary prices and the inability to raise ticket prices to a level allowing most theatres to make a profit. We are highly dependent on business purchases of tickets, which level is surely to fall and cause many theatres to close if the tax proposal is enacted.

Finally, governmental support of the arts is a recognized obligation of a civilized society. Most countries directly support their theatres many times more than we do in the U.S. We should be leading the pack, not following behind.

I will be happy to answer any questions you may have.

SUPPORTING THE ARTS:

An International Comparative Study

Canada
Federal Republic of Germany
France
Italy
Great Britain
Netherlands
Sweden
United States

J. Mark Davidson Schuster

Figure 2: Operating Income of Theaters by Source
One Selected Institution per Country

Figure 2a: Earned Income and Private Donations

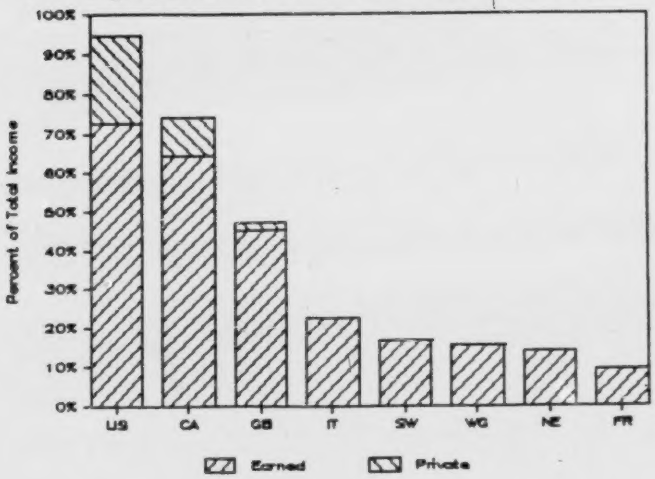
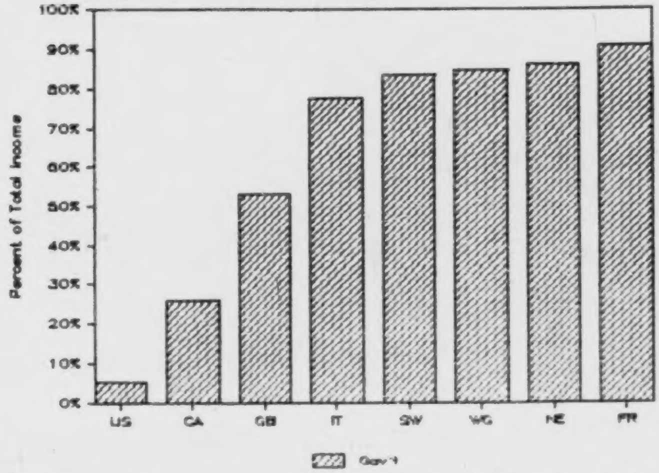


Figure 2b: Government Support



Note: To facilitate comparison each institution is identified by its country rather than by its individual name.

Source: David Cwi and Michael Quine, "Public and Private Arts Support in North America and Europe: Income Data for 32 Cultural Institutions," Department of Arts Policy and Management, City University (London), 1985.

R

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October 1, 1985

BIRCH E. BAYH, JR.
PARTNER

The Honorable Bob Packwood
United States Senate
259 Russell Senate Office Building
Washington, D. C. 20510

Dear Bob:

You are well aware of the deep concern engendered within the sports industry over the Administration tax proposal which would eliminate the deduction for sports tickets utilized for business purposes. As should be expected, much of this concern is centered around the negative financial impact this proposal will have throughout the various sports leagues, particularly the disastrous effect the elimination of the sports tax deduction will have upon the large number of teams which are either losing money or only making a very small margin of profit.

Those of us who represent the Sports Coalition (Major League Baseball, the NFL, the NHL, NASCAR and the NBA) have been working closely together to document for your consideration, the full negative impact of this provision, not only upon the sports businesses, but also upon the communities in which the teams are located and upon federal tax revenues which are derived from sports and related business activity. We asked Dr. Edward Shils, a professor at the Wharton School of Business at the University of Pennsylvania, widely acknowledged as the nation's foremost expert in assessing the economic impact which sports teams have upon the communities in which they are located, to study the proposal to eliminate the sports business deduction and to provide his assessment of its economic impact and its impact upon federal tax revenue.

Unfortunately, the Senate study may not be finalized in time for presentation at the Senate Finance Committee hearings. Thus, for your consideration, I have attached a copy of Dr. Shils' preliminary findings which conclude that the sports business tax proposal as introduced, would have a significant negative economic impact upon the affected communities and would actually result in the loss of as much as $2.5 billion of federal tax revenue. The American sports industry believes there are a number of important reasons for maintaining the sports business deduction. However,

THE PARTNERSHIP INCLUDES ONE OR MORE PROFESSIONAL CORPORATIONS

since you are charged with the sobering responsibility of drafting national fiscal policy and determining the best way to deal with budgetary deficits, we thought you would be particularly interested in studying Dr. Shils' conclusions that eliminating the sports business deduction will result in increasing the budgetary deficit problem. As Dr. Shils noted on page three of the attached report:

> "I was able to ascertain that the proposed provision in the IRS Code that would disallow sports entertainment as a deductible business expense was not based upon any estimate of revenue gain or revenue loss. I believe that it is extremely important that Members of Congress understand that the U.S. Treasury will lose in 1986 approximately $1 billion to $1.7 billion in tax collections, based only on football, baseball, basketball and hockey; and possibly lose as much as $2.5 billion when all professional and amateur sports of every variety are included."

Dr. Shils or any of us who represent the various sports leagues will be available to answer any questions you may have about this issue. Frankly, I do not envy your task of resolving the tax reform and budgetary problems. However, Bob, I am confident that these matters are in reliable hands.

Best regards,

Birch

Birch Bayh

BB/mkh

Enclosure

Bob -
Let me know if you have
any questions
Birch

PRELIMINARY FINDINGS OF THE IMPACT OF PROPOSED IRS CODE CHANGES ON THE GROSS NATIONAL PRODUCT GENERATED BY PROFESSIONAL SPORTS IN PHILADELPHIA AND THE U.S.A.

as well as

THE IMPACT OF PROPOSED IRS CODE CHANGES WHICH SERVES TO REDUCE FEDERAL TAX COLLECTIONS IN 1985 - 1986

Study Director
Dr. Edward B. Shils
George W. Taylor Professor
of Entrepreneurial Studies
Wharton School
University of Pennsylvania
Philadelphia, Pennsylvania

September 25, 1985

UNIVERSITY of PENNSYLVANIA
PHILADELPHIA 19104

The Wharton School

WHARTON ENTREPRENEURIAL CENTER
EDWARD B. SHILS
Director
George W. Taylor Professor of Entrepreneurial Studies

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Steinberg Hall-Dietrich Hall/CC
(215) 898-4856

September 25, 1985

Senator Birch E. Bayh
Rivkin, Radler, Dunne & Bayh
1575 Eye Street, N.W.
Washington, D.C. 20005

Dear Senator Bayh:

My Wharton staff has now completed its preliminary study of how a revised-IRS Code, eliminating sports entertainment as a business tax deduction, would seriously impact and reduce the Gross National Product generated by professional sports in the Philadelphia Standard Metropolitan Statistical Area (SMSA), as well as in the United States.

This letter is preliminary to my final comprehensive report, which will be completed within the next few weeks. However, I am enclosing the basic statistical tables that will appear in the larger final report.

With the weakening of the manufacturing sector in Philadelphia over the years, manufacturing job losses have been balanced by employment gains in the service industries. Few realized how important professional sports were in the urban infrastructure in generating jobs and increased business activity for the area, until the release of my report on the Economic Contribution of Professional Sports, which was made public in January 1985.

The original report showed the economic impact of professional sports on the Philadelphia economy in 1983 to be $574,612,333. However, as a result of my current study of predictable behavior by businesses after proposed IRS Code changes, the impact would be reduced by $156,006,763 to a lower GNP in the Philadelphia SMSA of $418,605,970, a reduction of 27.1%.

In order to determine the future behavior of business after the contemplated tax changes would become effective, Wharton mailed out 2,825 questionnaires eliciting responses to its mailer (see Table 1C). As of September 23, 1985, 1,114 responses have been received or 39.4% of those mailed.

The marketing requirements for American companies make the subject of business sports entertainment serious and challenging, so that daily returns are still coming in from all over the U.S. However, I have had to cut off as of the 23rd of September, so that preliminary information could be provided at this time.

The statistical tables and the exhibits speak for themselves, but I would now like to outline, at this time, a summary of the key findings:

I Only 22.9% of those businesses who traditionally have entertained in the sports field will continue to entertain, despite changes in the IRS Code.

II The balance of responses indicated either a complete discontinuance (33.1%); a reduction of 75% (13.5%); a reduction of 50% (24.2%); a reduction of 25% (5.3%) , or a reduction of 1 to 10% (1.0%). When these results are converted to total full-time equivalents, I find a discontinuance rate of 56.9% of those companies who have traditionally entertained in the sports field.

In order to determine the negative impact in the Philadelphia SMSA (GNP), which earlier in this letter I concluded was $156,000,000, it was necessary to convert the "discontinuance" and other percentage reductions to "full-time equivalent" reductions. This is described in Table 1D.

III This results, as I have said earlier, in a loss of $156,006,763 of GNP in the Philadelphia SMSA on a 1983 basis.

IV I have projected both the GNP and the U.S. tax collections for the years 1983 through 1986 and have developed on a national basis what the loss in Gross National Product, and what the consequent loss might be in annual federal tax collections by virtue of the discontinuance rate by American businesses, in the event that the IRS Code is changed. The findings are based upon a "low or conservative" loss ratio; a "middle or less conservative" loss ratio, and a "higher and least conservative" loss ratio. These figures are consolidated in Table 10. The data, however, are repeated here as follows:

	Low (See Table 6)	Middle (See Table 8B)	Higher (See Table 9)
1983	$774,600,000	$1,333,800,000	$1,333,800,000
1984	841,080,000	1,333,800,000	1,487,800,000
1985	894,000,000	1,347,840,000	1,571,167,000
1986	977,880,000	1,361,880,000	1,704,716,000

It should be pointed out that even the higher estimate is still conservative, since it does not include motor sports, horse racing, boxing, wrestling, professional tennis, soccer and other miscellaneous professional sports. It also excludes business sports entertainment for amateur athletic events, such as "Big Ten" football; Army-Navy games and college basketball.

V Because my study is based upon an extrapolation of the Philadelphia SMSA GNP loss of $156,000,000 on a national basis, it is clear that my data are based only upon the following professional sports: baseball, football, basketball and hockey. Were all other professional sports included and were all other amateur sports included, the loss in federal tax revenue could possibly reach 2.5 billions in 1986.

My statistical methodology and the samples developed have been made in association with Professor F. Gerard Adams, Professor of Economics and Finance, and a co-founder of the Wharton Econometric Center. Dr. Adams worked with me on the first 1985 Philadelphia Study.

As the data in the statistical tables and exhibits indicate, the 56.9% full-time equivalent discontinuance rate is derived from responses from the Forbes Fortune 500 list; from a list of Amex-type regional corporations which respond generally to questionnaires from the Wharton Entrepreneurial Center; from a sample of businesses which are on the mailing lists of the Eagles, Phillies, Flyer's and 76ers, and from a list of small businesses located throughout the U.S. which are members of national trade associations.

All of the respondent materials are held in the offices of the Wharton Entrepreneurial Center at the University of Pennsylvania, and as the reader of this preliminary report will observe, the questionnaires provided the respondents with an opportunity of identifying themselves. Over one-third of the Fortune 500 corporations signed the returns, thus showing the strength of their convictions. In addition, we have saved the return envelopes, which show the city of origin on the postmark.

Senator Bayh, I would be very happy to have any member of the staffs of either the House Ways and Means Committee or the Senate Finance Committee contact me with respect to my research methodology or my findings.

I was able to ascertain that the proposed provision in the IRS Code that would disallow sports entertainment as a deductible business expense was not based upon any estimate of revenue gain or revenue loss. I believe that it is extremely important that members of Congress understand that the U.S. Treasury will lose in 1986 approximately 1 billion to 1.7 billions in tax collections, based only on football, baseball, basketball and hockey; and possibly lose as much as 2.5 billions when all professional and amateur sports of every variety are included.

Due to the importance of the service industries to the economy of the United States, we here at Wharton are delighted to submit a second report in the series begun in January 1985, and I would be more than happy to testify on the work done thus far before any Congressional Committee.

Yours very sincerely,

Edward B. Shils

EBS:kar

Enclosure

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Enclosed is a very short questionnaire which will facilitate my economic research in connection with proposed revisions of the Internal Revenue Service Code as they pertain to the deductibility for tax purposes of sports entertainment expenditures.

Under the current law, sports entertainment expenses have been generally held to be deductible by IRS if the expenses bear a reasonable and proximate relation to the taxpayer's trade or business or to activities engaged in for profit. Tickets to sporting events and the costs of skyboxes, lounges, boxes or other similar arrangements that provide the taxpayer a specific viewing area to a sporting event, are generally fully deductible if they meet the "directly related to" or "associated with" tests for acceptable business entertainment activities.

The revised IRS Code would eliminate sports entertainment as a business tax deduction under the proposed IRS rules. My research is directed to measuring the economic impact of these tax revisions on the economies of metropolitan areas.

I would appreciate your cooperation in this research. The enclosed form only requires ONE check mark! Please return the form to me in the enclosed self-addressed, stamped envelope at your earliest convenience.

Yours very sincerely,

Edward B Shils

Edward B. Shils

EBS/prp
Enclosures

UNIVERSITY of PENNSYLVANIA

PHILADELPHIA 19104

The Wharton School

WHARTON ENTREPRENEURIAL CENTER
EDWARD B. SHILS
Director
George W. Taylor Professor of
Entrepreneurial Studies

DIETRICH HALL/CC
(215) 898-4856

Dear Dr. Shils:

If sports entertainment is no longer tax deductible under a revised IRS Code; my decision to buy tickets for business entertainment purposes would be as follows:

(Please check ONLY one of the boxes below):

☐ I will discontinue sports entertainment for business purposes, completely.

I will reduce my business sports entertainment budget by:

☐ About 25%
☐ About 50%
☐ About 75%
☐ Other _____%

☐ I will continue my business sports entertainment expenditures as in the past (no change).

☐ I do not currently purchase tickets to sports events for business entertainment purposes.

(OPTIONAL)

Name ____________________ Company ____________________

Title ____________________ Address ____________________

TABLE 1

THE BENEFITS TO THE PHILADELPHIA ECONOMY, GENERATED BY INTEREST IN PHILADELPHIA PROFESSIONAL SPORTS BY PAYMENTS FROM WITHIN AND OUTSIDE THE CITY OF PHILADELPHIA

1983

	From Insiders City of Phila.	From Outsiders City of Phila.	From Visiting Teams	From Visiting Scouts	Total Direct
TABLE—A					
I. Revenues Generated by Teams & Spectrum Directly					
Tickets for Games or Events	$22.665.000	$ 45.603.000			$ 68,268,000
Concessions (Payments by Fans)	5.742.660	11.659.340			17,402:000*
TV & Radio Payments to Teams	11.046.334	22.648.666			33.695.000
Misc. Team Revenues	5.699.000	—	—	—	5,699,000
Sub-Total	$45.152.994	$ 79.911.006			$125.064.000*
TABLE—B					
II. Payments Made by Spectators, Fans & Visiting Teams					
Food & Entertainment:					
Restaurants, Bars, Clubs, Hotels	$11.472.000	$ 23.325.000	$272.000	$ 78.000	$ 35,147,000
Hotels, Motels & Lodging	—	11.750.000	376.000	31.000	12.157.000
Gasoline & Auto Exp.	965.416	2.937.500			3,902,916
Parking	2.300.000	4.700.000			7.000.000
Public Transportation	1.789.000	213.000			2.002.000
Taxis, Private Buses, Baggage, etc.	819.000	273.520	144.000	—	1.236.520
Sub-Total	$17.345.416	$ 43.199.020	$792.000	$109.000	$ 61,445.436
III. Additional Revenue Paid by Advertisers to Ch. 29, Ch. 17, WCAU, WIP for Ads Run During Phillies, Sixers, Eagles, Flyers Games Incl. Ad. Agency Commissions	$ 9.325.175	$ 6.131.825	—	—	$ 15.457.000
Grand Total— Total Direct Income Resulting From Sports Consortium Activ.	**$71,823,585**	**$129,241.851**	**$792.000**	**$109,000**	**$201.966.436****

---

*Includes $2.739.000 of Concession Income to City of Phila. not included in Table 8, which covers only income to Consortium members, as well as income to the teams and to the consessionaires.

**Does not include a potential income to the Philadelphia economy of $16.104.000 per year which may accrue to the City's economy by virtue of the establishment of cable television. It is estimated that at a 50% penetration rate that there will be 122.000 subscribers in Philadelphia at an estimated monthly rate of $11 × 12 months, or $16,104,000. This will take place in a year or two.

TABLE 1B

CALCULATED CHANGES IN GATE RECEIPTS PHILADELPHIA PROFESSIONAL SPORTS COMPARING RECEIPTS IN 1983 WITH THOSE EXPECTED AFTER CHANGES IN THE IRS CODE ELIMINATING SPORTS ENTERTAINMENT BUSINESS EXPENSES AS TAX DEDUCTIBLE

Part A

Line #			
#1	Total Gate Receipts 1983 (Table 1)	$68,268,000	
#2	Estimates by Eagles, Phillies, 76's and Flyers (weighted average of 46.6605% of total receipts) are daily tickets purchased by individuals and other non-business season ticket purchases	31,860,400	(46.66%)
#3	Balance = Estimates of business gate receipts for boxes, and other season ticket purchases.	$36,407,600	(53.33%)

Part B

#4	Business Gate receipts estimated 1983	$36,407,600
#5	Estimated reduction in business gate receipts by virtue of expected changes in IRS Code (Wharton Study shows a weighted average reduction of 56.9% (see Tables 1C and 1D)	20,715,924
#6	Business Season ticket holders who will continue as formerly (see Tables 1C and 1D)	$15,691,676

Part C

Gate receipts to continue by virtue of non-business aspects (see Line #2)	$31,860,400
Balance of businesses which will continue to entertain despite tax changes (see Line #6)	15,691,676
Estimated revised 1983 gate receipts for professional teams in Philadelphia (see Tables 1 and 1E)	$47,552,076

TABLE 1C

Results from Wharton Questionnaire
Distributed to 2825 Companies
During the period Aug. 23, 1985 to Sept. 23, 1985
To Determine Future Behavior With Respect
To Sports Entertainment If These
Expenses Are No Longer Deductible
For Federal Tax Purposes

	Respondents Who Discontinue Or Reduce Sports Entertainment										
	100%	75%	50%	25%	Other (1-10%)	Continue As Before	Total Who Entertain	Don't Entertain	Total Responses	Total Mailed	% Returned
Fortune Forbes-500	35	24	43	11	2	62	177	141	318	790	40.3%
WEC-Donor Regional Amex Co.	33	12	35	3	0	34	117	59	176	335	52.5%
Eagles, Phillies, Flyers & 76er's	120	51	83	21	4	51	330	31	361	900	40.1%
Misc. National Small Business	53	11	15	4	1	20	104	155	259	800	32.4%
TOTAL	241	98	176	39	7	167	728	386	1,114	2,825	39.4%
% TOTAL	33.1%	13.5%	24.2%	5.3%	1.0%	22.9%	100%				
% Total Responses							65.4%	34.6%	100%		

TABLE 1D

Respondents Expected Behavior After Proposed Changes In The IRS Code In Re Sports Entertainment Expenditures

Rate of Reduction	# Responses	Conversion of Rate of Reduction to Full Time (100%) Equivalents
Discontinue - 100%	241	241
Reduce by - 75%	98	74
Reduce by - 50%	176	88
Reduce by - 25%	39	10
Reduce by Other - 1-10%	7	1
Continue as before	167	0
Total	728	414

Summary

Total Responses	728
Total Responses Indicating Discontinuance or Reductions on a Full Time Equivalent Basis	414
Expected Percentage Reduction in Attendance by Those Who Presently Utilize Sports Entertainment as a Deductible Business Expense	56.9%

TABLE 1E

ADJUSTED NET BENEFITS TO THE PHILADELPHIA ECONOMY, GENERATED BY INTEREST IN PHILADELPHIA PROFESSIONAL SPORTS BY PAYMENTS FROM WITHIN AND OUTSIDE THE CITY OF PHILADELPHIA

(Table 1E indicates the reductions in direct revenues, which may be expected as a result of expected behavior on the part of businesses in reducing sports entertainment after the IRS Code is amended to deny sports entertainment as a deductible expense)

TABLE -- A	Total Revenues Carried Over From Table 1	Reductions in Revenues Accounted for by Proposed Changes in IRS Code	Adjusted Direct
1. Revenues Generated by Teams & Spectrum Directly			
Tickets for Games or Events	$68,268,000	$20,715,924	$47,552,076
Concession (Payments by Fans)	17,402,000	6,091,400	11,310,600
TV & Radio Payments to Teams	33,695,000	6,739,000	26,956,000
Misc. Team Revenues	5,699,000	569,900	5,129,100
Sub Total	$125,064,000	$34,116,224	$90,947,776
TABLE -- B			
2. Payments Made by Spectators, Fans & Visiting Teams			
Food & Entertainment: Restaurants, Bars, Clubs, Hotels ..	$35,147,000	$12,301,450	$22,845,550
Hotels, Motels, & Lodging	12,157,000	4,254,950	7,902,050
Gasoline & Auto Exp.	3,902,916	1,170,874	2,732,042
Parking	7,000,000	2,450,000	4,550,000
Public Transportation	2,002,000	300,300	1,701,700
Taxis, Private Buses, Baggage, etc.	1,236,520	432,782	803,738
Sub Total	$61,445,436	$20,910,356	$40,535,080
3. Additional Revenue Paid by Advertisers to Ch. 29, Ch. 17, WCAU, WIP for Ads Run During Phillies, Sixers, Eagles, Flyers Games Incl. Ad Agency Commissions	$15,457,000	$ 3,091,400	$12,365,600
Total Direct Income Resulting From Sports Consortium Activities .	$201,966,436	$58,117,980	$143,848,456

TABLE 2

TOTAL DIRECT AND INDIRECT ECONOMIC CONTRIBUTIONS MADE BY THE SPORTS CONSORTIUM TO THE ECONOMY OF THE CITY OF PHILADELPHIA

1983

A. Direct Economic Contributions		
I. Revenues Generated by Teams, Spectrum and other related facilities Directly (See Table 1)	$125,064,000	
II. Payments made by Spectators & Fans & Visiting Teams (See Table 1)	61,445,436	
III. Additional Revenues paid by Advertisers (See Table 1)	15,457,000	
Total Direct		$201,966,436
IV. Indirect Economic Contributions to Philadelphia "Multiplier Effect"		
—Purchasing Power for Players, Non-Players, Payrolls		
—GNP Generated by 3,000 Vendors of Sports Teams		
—Allied Economic Activities (Retail Trade & Services, Electric Power, Stadium, etc.)		
—With Each Round of Expenditures of Original "Direct" Monies; Local Phila. Incomes Increase but in a Diminishing Chain*		
Hence: $201,966,436 (Direct) × 1.7 (Multiplier for City of Phila.)*		
Multiplier Increment		$141,376,505
Total Direct and Indirect Impact ($201,966,436 × 1.7) =		**$343,342,941******

---

*Calculations by Prof. F. Gerard Adams, Professor of Economics and Finance, Director of Economic Research Unit, University of Pennsylvania; also Glickman Report using the Philadelphia Econometric Model; also Walter Isard, *Methods of Regional Analyses*, N.Y., John Wiley & Sons, 1960, Chpt. 6, *Economics Base Multipliers*, also Sept. 22, 1981 Studies of Wharton Econometric Forecasting Associates, Inc. showing multipliers for employment for Philadelphia 1.7 for City and 2.6 for Phila. SMSA. (See Exhibit 1, Professor Adams' letter of October 18, 1984) ***

**Does not include a potential income to the Philadelphia economy of $16,104,000 per year which may accrue to the City's economy by virtue of the establishment of cable television. It is estimated that at a 50% penetration rate that there will be a 122,000 subscribers in Philadelphia at an estimated monthly rate of $11 × 12 months, or $16,104,000. This will take place in a year or two.

***See January 1985 Report.

TABLE 2A

TOTAL DIRECT AND INDIRECT ECONOMIC CONTRIBUTIONS MADE BY THE SPORTS CONSORTIUM TO THE ECONOMY OF THE CITY OF PHILADELPHIA

1983

(As Amended by Anticipated Reductions in Revenues Generated by Sports -- After the IRS Changes)

A. Direct Economic Contributions

I.	Revenues Generated by Teams, Spectrum and other related facilities Directly (See Table 1E)	$ 90,947,776
II.	Payments made by Spectators & Fans & Visiting Teams (See Table 1E)	40,535,080
III.	Additional Revenues paid by Advertisers (Table 1E)	12,365,600
	Total Direct	$143,848,456

B. Indirect Economic Contributions to Philadelphia "Multiplier Effect"

- Purchasing Power for Players, Non-Players, Payrolls
- GNP Generated by 3,000 Vendors of Sports Teams
- Allied Economic Activities (Retail Trade & Services, Electric Power, Stadium, etc.)
- With Each Round of Expenditures of Original "Direct" Monies; Local Phila. Incomes Increase but in a Diminisning Chain

Hence: $143,848,456 (Direct After Reductions)
x 1.7 (Multiplier for City of Phila.)

Multiplier Increment $100,693,909

C. Total Direct and Indirect Impact (143,848,456 x 1.7) = $244,542,365

TABLE 3

ECONOMIC IMPACTS RESULTING FROM BOTH DIRECT AND INDIRECT CONTRIBUTIONS OF SPORTS CONSORTIUM IN PHILADELPHIA SHOWING MULTIPLIER EFFECT ON BOTH THE ECONOMIES OF THE CITY OF PHILADELPHIA AND THE STANDARD METROPOLITAN STATISTICAL AREA

1983

City of Philadelphia Only		
I. Direct Economic Contributions (incl. adv. revenue) (See Table 1)	$201,966,436	
II. Multiplier 1.7 = $343,342,941 or an increment of (Indirect)*	141,376,500	
Total Philadelphia (City) Direct and Indirect	$343,342,941	
Other Relevant Impacts		
A. Impact on the Philadelphia SMSA 2.6 × direct impact of $201,966,436 or $525,112,733 hence additional regional increment of*	$181,769,792	
Total Regional Impact of Sport Complex—Philadelphia SMSA		$525,112,733
B. **Illustrative Item** showing interdependence of SMSA and Sports Consortium		
Revenue generated by PRISM—Basic Programming Revolves around Sports Events—Sixers, Flyers, Phillies, etc.		
Subscribers—375,000 @ $11/month average Paid to PRISM and cable operators × 12 months		$49,500,000**
Total for Regional (Partial Est.)		**$574,612,733****

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*See Professor Adams' letter of October 18, 1984 as Appendix Exhibit 1 in rear of report (January 1985 report)

**Does not include future annual income to the economy of the City of Philadelphia generated by cable T.V. in the City. It is estimated that PRISM will yield a 50% penetration or 122,000 subscribers at an estimated $11/mo or $16,104,000 additional to the City.

TABLE 3A

ECONOMIC IMPACTS RESULTING FROM BOTH DIRECT AND INDIRECT CONTRIBUTIONS OF SPORTS CONSORTIUM IN PHILADELPHIA SHOWING-MULTIPLIER EFFECT ON BOTH THE ECONOMIES OF THE CITY OF PHILADELPHIA AND THE STANDARD METROPOLITAN STATISTICAL AREA

(As Amended by Anticipated Reductions in Revenues Generated by Sports--After the IRS Changes)

City of Philadelphia Only		
I. Direct Economic Contributions (incl. adv. revenue). (See Table 2A)	$143,848,456	
II. Multiplier 1.7 = $244,542,365, or an increment of (Indirect)	100,693,909	
Total Philadelphia (City) Direct and Indirect (See Table 2A)	$244,542,365	
Other Relevant Impacts		
A. Impact on the Philadelphia SMSA 2.6 × direct impact of $143,848,000, or $374,005,970, hence additional regional increment of	$129,463,605	
Total Regional Impact of Sports Complex — Philadelphia SMSA (after reductions)		$374,005,970
B. Illustrative Item showing interdependence of SMSA and Sports Consortium		
Revenue generated by PRISM — Basic Programming Revolves around Sports Events — Sixers, Flyers, Phillies etc., (Reduced by $4,900,000 from Table 3)		44,600,000
Total for Region (after expected reductions in economic impact)		$418,605,970

TABLE 4

ORIGINAL AND REDUCED ECONOMIC IMPACTS RESULTING FROM BOTH DIRECT AND INDIRECT CONTRIBUTIONS OF SPORTS CONSORTIUM IN PHILADELPHIA SHOWING MULTIPLIER EFFECT ON BOTH THE ECONOMIES OF THE CITY OF PHILADELPHIA AND THE STANDARD METROPOLITAN STATISTICAL AREA 1983

(As Amended by Anticipated Reductions in Revenues Generated by Sports -- After the IRS Changes)

Original Economic Impact on Philadelphia (SMSA made by Professional Sports (Table 3)	$574,612,733
Reduced Economic Impact on Philadelphia (SMSA) made by Changes in the IRS Code -- in re: Deductability of Sports Entertainment Expenditures (Table 3A)	$418,605,970
Estimated Loss in Economic Activity — For the Philadelphia (SMSA)	$156,006,763
Percent Loss to the Economy of Greater Philadelphia Metropolitan Area (1983 data)	27.1%

Table 5

Actual & Estimated U.S. Gross National Product, Personal Income And Tax Collections 1983 - 1986[1]

Part A	GNP (trillions)	Personal Income (trillions)
1983	$3,305.0	$2,744
1984	3,662.8	3,012
1985	3,868.0	3,189
1986	4,198.0	3,442

Part B — U.S. Gross Tax Collections (Before Refunds)[2] In Billions

	1983	1984	1985 (Est.)	1986 (Est.)
Individual Income	$349.6	$362.9		
Corporation Taxes	61.8	74.2		
Employment Taxes (Social Security; Federal Insurance Contributions; Self-employment Insurance Contributions; Unemployment Insurance; Railroad Retirement Contributions)	173.8	199.2		
Excise	35.7	38.0		
Other (Misc.)	24.6	26.6		
Totals	$645.5	$700.9	$745.1	$814.9

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1. Sources for Actual GNP, Personal Income for 1983, 1984 & 1985 are Federal Reserve Board; data for 1985 & 1986 were also derived from U.S. Budget estimates.

2. Sources for U.S. Tax data are the Reports of the IRS Commissioner and Counsel for 1983 and 1984. 1985 and 1986 estimates are from U.S. Budget Estimates and are probably net after refunds, and hence, actual Gross Tax Collections should be higher by approximately 80 to 100 billions.

Table 6
LOW
CONSERVATIVE APPROACH TO LOSS IN FEDERAL TAXES DUE TO IRS CODE CHANGES IN RE SPORTS ENTERTAINMENT

1983 - 1986 Estimates

Assumption: Philadelphia's Loss in GNP, per Tables 3A & 4, is $156 millions. If approximately 30 Sports Centers had an average loss of $130 millions, the national GNP loss would be $3.9 billions (see Table 7).

1983 U.S. GNP (Table 5)	$3.305 trillions
Philadelphia SMSA loss is... (see Tables 3A & 4) hence	$156,000,000
Take Average Loss of $130 millions x 30 Sports Centers = (see Table 7)	$3.9 billions = (.0012) or 0.12%

U.S. Loss in Revenues on 1983 Basis

1983 U.S. Tax Collections	645.5[1]	billions (see Table 5)
	x 0.12%	GNP Loss
U.S. Loss	$774,600,000	

U.S. Loss in Revenues in 1984

1984 U.S. Tax Collections	700.9[2]	billions
	x 0.12%	GNP Loss
U.S. Loss	$841,080,000	

U.S. Loss in Revenues in 1985

1985 U.S. Tax Collections Est.[3]	745.0[3]	billions
	x 0.12%	GNP Loss
U.S. Loss	$894,000,000	

U.S. Loss in Revenues in 1986

1986 U.S. Tax Collections Est.[4]	814.9	billions
	x 0.12%	GNP Loss
U.S. Loss	$977,880,000	

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1. Source: IRS Commissioner
2. Source: IRS Commissioner
3. U.S. Budget Estimates
4. U.S. Budget Estimates

Table 7

ESTIMATED REDUCTION IN GNP BY REGION
OCCASIONED BY PROPOSED CHANGES IN IRS CODE

(Based on 1983 Franchises)*

No. of Areas		No. of Teams	Estimated GNP loss (Millions)
1	Texas	9	$300
2	Los Angeles & Anaheim	8	300
3	Chicago, Illinois	6	250
4	New York City	5	250
5	N. J. Meadowlands	5	250
6	Detroit	5	200
7	San Francisco & Oakland, California	5	225
8	New England, Boston & Hartford	4	150
9	Philadelphia	4	156
10	Washington D.C.	4	125
11	Florida	4	150
12	Pittsburgh	4	100
13	Minnesota	3	100
14	Wisconsin	3	100
15	St. Louis	3	100
16	Atlanta	3	100
17	Cleveland, Ohio	3	100
18	Denver, Colorado	3	100
19	Kansas City	3	100
20	State, Washington	3	100
21	Baltimore	2	75
22	Cincinnati, Ohio	2	75
23	Oregon	2	75
24	Arizona - Phoenix	2	75
25	San Diego, California	2	75
26	N.Y. State, Buffalo	2	75
27	Indiana	2	75
28	Tennessee & Alabama	2	75
29	Utah	1	25
30	Oklahoma	1	25
31	Louisiana	1	40
Totals USA			
31		106**	$3,945 (billions)

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*Includes only professional football, baseball, basketball, and hockey teams.

**106 excludes Canadian teams in 1983.

Table 8A

DATA SHOWS PHILADELPHIA MODEL ON BOTH

GNP POPULATION -- 1984

SHOWS A CONSISTENT BASIS

	GNP	POPULATION
U.S.	$3,662.8 trillions (1984)	228 millions (1980)
Philadelphia SMSA	$78 billions (1984)	5 millions (1980)
Ratio	2.12	Ratio 2.18*

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* U.S. population is 45 x Philadelphia population (see Table 8B).

Table 8B

MIDDLE AND LESS CONSERVATIVE APPROACH TO LOSS IN FEDERAL TAXES DUE TO IRS CODE CHANGES TO DISALLOW SPORTS EXPENDITURES AS BUSINESS DEDUCTIONS
(Population Basis)

1983 Philadelphia (SMSA), GNP Loss (Table 4) ----- $156,000,000

U.S. Population, 1980 = 228 million
Philadelphia SMSA population 1980 = 5 million
Philadelphia population is 2.18% or (2.2%) of U.S. population
U.S. population is 45 times the Philadelphia SMSA

hence, multiply ...

Philadelphia Loss in Sports GNP -------	$156,000,000
x 45	x 45
to attain U.S. GNP loss for 1983 =	7,020,000,000

1983 Take GNP = 3,305 Trillions (table 5)
1983 Tax Collections = 645.5 Billions (table 5)
Taxes Ratio to GNP = 19%

	$7,020,000,000
	x 19%
1983 Federal Tax Loss	$1,333,800,000

1984 GNP (table 5)	3,662.8 trillions
1984 Federal Tax (table 5)	700.9 billions
Taxes Ratio to GNP =	19%

	$7,020,000,000
	x 19%
1984 Estimated Federal Tax Loss ...	$1,333,800,000

1985 GNP Estimated (table 5)	$3,662.8 trillions
1985 Federal Tax Estimate (table 5)	700.9 billions
Taxes Ratio to GNP =	19.2%

	$7,020,000,000
	x 19.2%
1985 Estimated Federal Tax Loss ...	$1,347,840,000

1986 GNP Estimated (table 5)	$4,198 trillions
1986 Federal Tax Est. (t. 5)	814.9 billions
Taxes Ratio to GNP =	19.4%

	$7,020,000,000
	x 19.4%
1986 Estimated Federal Tax Loss ...	$1,361,880,000

TABLE 9

HIGHEST AND LEAST CONSERVATIVE APPROACH TO LOSS IN FEDERAL TAXES DUE TO IRS CODE CHANGES TO DISALLOW SPORTS EXPENDITURES AS BUSINESS DEDUCTIONS (Population Basis)

1983 GNP = 3,305 trillions (Table 5)

Loss in Federal Tax Revenue (1983) (see Table 8B)	$1,333,800,000

1984 GNP = 3,662.8 trillions (Table 5)

Loss in Federal Tax Revenue (1983)	$1,333,800,000
Add increased loss due to GNP increase over 1983	154,050,000
Loss in Federal Tax Revenue (1984)	$1,487,850,000

1985 GNP = 3,868 trillions (table 5)

Loss in Federal Tax Revenue (1984)	$1,487,850,000
Add increased loss due to GNP increase over 1984	83,317,000
Loss in Federal Tax Revenue (1985)	$1,571,167,000

1986 GNP = 4,198 trillions (table 5)

Loss in Federal Tax Revenue (1985)	$1,571,167,000
Add increased loss due to GNP increase over 1985	133,549,000
Loss in Federal Tax Revenue (1986)	$1,704,716,000

TABLE 10

ESTIMATED REDUCTIONS IN COLLECTION OF U.S. TAXES
BASED UPON PHILADELPHIA'S EXPERIENCE IN
REDUCED GNP FOR 1983 OCCASIONED BY
PROPOSED CHANGES IN IRS CODE
PERTAINING TO SPORTS ENTERTAINMENT

	LOW (See Table 6)	MIDDLE (See Table 8B)	HIGHER* (See Table 9)
1983	$774,600,000	$1,333,800,000	$1,333,800,000
1984	841,080,000	1,333,800,000	1,487,800,000
1985	894,000,000	1,347,840,000	1,571,167,000
1986	977,880,000	1,361,880,000	1,704,716,000

*Highest estimate is still conservative, since it does not include motor sports, horse racing, boxing, wrestling, professional tennis, soccer and other miscellaneous professional sports. It also excludes business sports entertainment for amateur athletic events, such as "Big Ten" football; Army-Navy games; college basketball. The loss in tax revenue could reach 2.5 billions in 1986.

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THE ROBERT MORRIS ASSOCIATES

NATIONAL OFFICE PHILADELPHIA NATIONAL BANK BUILDING • PHILADELPHIA, PA • 19107
ESTABLISHED 1914 • THE NATIONAL ASSOCIATION OF BANK LOAN AND CREDIT OFFICERS

EDWARD J. WILLIAMS
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October 1, 1985

The Honorable Bob Packwood
Chairman
Committee on Finance
United States Senate
221 Senate Dirksen Office Building
Washington, DC 20510

RE: Section 585, Loan Loss Reserves for Commercial Banks

Dear Mr. Chairman:

Robert Morris Associates, the professional association of commercial loan and credit officers, is writing this letter to express opposition to the Treasury Department proposal to eliminate the reserve method of accounting for bad debts. We request that it be made part of the record of hearings being held on tax reform.

There are three major reasons for our opposition:

- The reserve method has proved its worth in protecting banks from the effects of major losses;
- Automatic charge-off standards may increase collection problems for banks; and
- The motivation for the change is based partly on the erroneous premise that banks are not paying a fair share of corporate income taxes.

Before discussing more fully each of these points of opposition, we will establish perspective and context with a chronological and substantive presentation of the history of the reserve for bad debts for commercial banks.

Rationale for Reserve Method

Since 1921, all businesses have been allowed to deduct additions to bad debt reserves, thereby accumulating such reserves out of pre-tax, rather than after-tax, income. The reserve treatment of bad debts (as opposed to the specific charge-off method) contributes to proper income measurement.

When a business makes sales (for banks, the sales are interest and fees on their investment in loans) and incurs accounts receivable, it knows that statistically a certain percentage of those receivables are likely to become bad debts. According to the principles of accrual basis accounting, to avoid an overstatement of profit during the reporting period of the sale, the cost of the bad debts is allocable to, and properly deductible against, the sales which generated those receivables. Therefore, some estimate of their cost should be deducted as an addition to bad debt reserves when the income from the sales is reported. When actual defaults occur, under this theory the bad debts should first be charged against the bad debt reserve and should only be deductible to the extent they exceed the amount previously deducted as an addition to the bad debt reserve.

Under present law, a widely accepted method of determining a reasonable addition to a reserve for bad debts is an experience method as described in the case of Black Motor Co. (Black Motor Co., Inc. v. Commissioners, 41 B.T.A. 300 (1942).) The Black Motor Co. case adopted a six year moving average method for determining a business' addition to its bad debt reserve. This rule generally was adopted statutorily as one method for determining a financial institution's annual addition to its loan loss reserve.

Legislative History of Reserve Method

Prior to 1969, bad debt reserves of commercial banks were determined under administrative rulings. Until 1965, banks were allowed to accumulate a reserve of up to three times the 20-year average of their losses as a percentage of loans. In 1965, the Treasury Department granted banks the privilege, on an industry-wide basis, of building up a bad debt reserve equal to 2.4% of eligible loans. In 1968, the loan base was restricted to exclude certain loans on which banks could not suffer economic loss.

In 1969 Congress made a radical departure in the manner in which bad debt reserves of banks were viewed. The focus changed from providing substantial reserves to protecting banks against possible catastrophic losses to that of determining the proper effective tax rate for banks. The Treasury argued that in the long run commercial banks should not be treated more favorably than other taxpayers in building up bad debt reserves.

As a consequence, Congress provided in the Tax Reform Act of 1969 that the percentage bad debt deduction previously afforded to commercial banks would be phased out over a period of 18 years. Unless bad debt experience supported a larger bad debt deduction than the percentage bad debt deduction, commercial banks were limited to build up their reserves to:

- 1.8% of such loans for taxable years beginning after July 11, 1969, and before 1976;
- 1.2% of eligible loans for taxable years beginning after 1975 and before 1982, and
- 0.6% of eligible loans for taxable years beginning after 1981 and before 1988.

For taxable years beginning after 1987, the percentage method was eliminated and commercial banks will be required to base their deductions for additions to bad debt reserves on their actual losses for the current and five preceding years. This procedure is generally used by other taxpayers.

Although Congress considered the new limitations on bad debt reserves adequate to cover losses, the net operating loss carryback rules were amended to provide an extra margin of safety to protect against the possibility of unusually large bad debt losses. Under the new rules, banks were permitted to carryback net operating losses for ten years instead of three years.

In the Economic Recovery Tax Act of 1981, the phase-down of the percentage from 1.2 to 0.6 was delayed from 1982 to 1983, and a percentage of 1.0 established for the year 1982. The Tax Equity and Fiscal Responsibility Act of 1982 reduced the excess bad debt reserve deduction of both banks and thrift institutions by 15% as part of an across-the-board cutback in tax preferences.

Present Rules

Under present law, taxpayers are permitted a deduction for any debt which is acquired or incurred in the taxpayer's trade or business which becomes wholly or partially worthless during the taxable year. This deduction may be computed under either of two methods. Under the "specific charge-off method," specific bad debts may be deducted in the year in which they become worthless or partially worthless. Under the "reserve method," a deduction is permitted, at the discretion of the Secretary of the Treasury, for a reasonable addition to a reserve for bad debts. When debts are determined to be totally or partially worthless, no deduction is allowed, but the amount of the bad debt is charged against the reserve (e.g., the reserve is reduced). The taxpayer's method of computing the annual addition to the bad debt reserve will allow him to deduct an amount needed to increase the reserve to the appropriate level.

Commercial banks are permitted to use the specific charge-off method, although few do. But they may use several methods of computing bad debt reserves. A commercial bank is allowed a deduction for an annual addition to its loan loss reserves equal to the greater of the amounts computed under either the "experience" or "percentage of eligible loan" method.

Experience method. Broadly speaking, under the experience method, the computation of the addition to the reserve for bad debts involves the use of a 6-year relationship of total bad debts annually to the sum of loans outstanding at the close of each year. An alternative method of computing the annual allowable addition to the reserve uses a base year figure, adjusted to reflect any decrease in loans outstanding. Taxpayers may use an averaging period shorter than six years with the approval of the Treasury, which may be given in cases where the taxpayer can demonstrate that there has been a change in the mix of a substantial portion of the loans outstanding such that the risk of loss is substantially increased.

After 1987, commercial banks are required to compute the deduction for additions to the reserve for bad debts solely under the experience method (or specific charge-off method).

Percentage of eligible loans method. Under the "percentage of eligible loans" method, an addition to the reserve for bad debts is allowable in an amount sufficient to increase the loan loss reserve at the close of the taxable year to a specified percentage of the eligible loans at the close of the taxable year. The specified percentage was 1.0% for 1982 and is 0.6% for 1983 through 1987. Thus, in the case of a bank whose eligible loan portfolio is expanding and which starts the year with a 0.6% bad debt reserve, the deduction for the addition to the bad debt reserve in a typical year will be the actual bad debt losses charged against the reserve during that year plus 0.6% of the increase in eligible loans during the year.

As is the case under the experience method, commercial banks utilizing the percentage of eligible loans method are permitted, at a minimum, a deduction sufficient to restore the balance in the loan loss reserve at the close of the taxable year to its base-year level so long as eligible loans have not decreased below their base-year level. If eligible loans have decreased below their base-year level, the minimum bad debt deduction permitted the bank will be reduced proportionately. In addition, the maximum addition to the reserve for losses on loans under the percentage method cannot exceed the greater of 0.6% of eligible loans outstanding at the close of the taxable year or an amount sufficient to increase the reserve for losses on loans to 0.6% of eligible loans at such time.

A commercial bank may switch between methods of determining the addition to its reserve for losses on loans from one year to another. Furthermore, a commercial bank need not adopt a method yielding the largest deduction, although the regulations do prescribe minimum deductions.

Under present law, if the bad debt reserve deduction for the taxable year determined under the above rules exceeds the amount which would have been an allowable deduction on the basis of actual experience, the allowable bad debt reserve deduction for the taxable year is reduced by 15% of the excess. Furthermore, 71.6% of the excess is an item of tax preference under the minimum tax.

With that background as guidance, we turn now to the arguments.

The Reserve Method Has Proved Its Worth In Protecting Banks From the Effects of Major Losses

In substance, the Treasury's proposal is a reversion to the years before 1921 when only specific net charge-offs were allowed as deductions. This method ignores the practical problem that there is no way to determine the exact portion of a loan portfolio to be charged off. Moreover, judgments among bankers vary as to when a loan has gone bad, so there is a possibility of some banks overstating the amount of bad loans for tax purposes.

In light of current economic conditions, bank regulatory agencies are encouraging banks to increase their loan loss provisions in order to diminish the risk of severe economic reversals from the cumulative effects of nonperforming loans due to business failures. Adequate reserves are necessary to ensure the safety and soundness of the banking system. Other taxpayers are allowed tax deductions for their normal business expenses. Since banks are required to maintain adequate reserves as part of their business operations, these expenses should also be allowed as tax deductions. The tax system should support this as a federal policy goal.

In looking at the tax treatment of bad debts in other countries, the overriding majority of countries allow the reserve method of accounting. In a 1983 study prepared by Peat, Marwick, Mitchell & Co., 27 countries were reviewed as to the allowable tax treatment for bad debts. Of the countries reviewed, only

Australia and Venezuela limit the deduction to specific charge-offs. Therefore, by requiring the specific charge-off method in the U.S., the U.S. tax system will be out of line with most of the country's major trading partners.

Automatic Charge-Off Standards May Increase Collection Problems for Banks

The Treasury proposal would repeal Section'166(c) of the Internal Revenue Code, which allows a taxpayer to deduct business bad debts by using the reserve method of accounting. This includes repeal of Section 585 which dictates how a commercial bank must compute its annual reserve addition. All taxpayers would be required to use the specific charge-off method.

Such an automatic charge-off standard could have as an adverse and unwanted consequence the alerting of customers to the bank's assessment of the likelihood of collecting the loan. A delinquent customer might decide that there is no need to continue paying on the loan if it is learned that the bank has decided that for tax purposes the loan will not be paid.

The possibilities of the customer's learning of the charge-off are not that remote. Section 184 of the Tax Reform Act of 1984 requires information return reporting on abandonments, foreclosures, and other acquisitions of property securing indebtedness. The Internal Revenue regulations (49 Fed. Reg. 34459, August 31, 1984) require the filing of information returns with the IRS and with the customer for loans covered by the amendments. If disclosures or similar reports were required at the time a loan was charged-off for tax purposes, the fear of increased collection difficulties would be realized.

The Motivation for the Change Is Based Partly on the Economic Premise That Banks Are Not Paying a Fair Share of Corporate Income Tax

Commercial banks are, in general, subject to taxation under the same rules as other taxable corporations. There seems to persist, however, a belief that banks must benefit from a number of "special" provisions in the Tax Code. The basis for this belief appears to be the various studies claiming to show that the effective tax rate of banks is very low. An examination of the tax law for those features that are important in studies of effective tax rates reveals that, by and large, "special provisions" or "tax preferences" are not involved. Instead, the single most important factor in reducing the federal income taxes paid by banks is the exemption for interest paid by state and local governments on their obligations. Another large component of the reduction for major institutions is the credit allowed for foreign taxes imposed by other countries on income earned by the taxpayer in those countries. A third large component is the combined effect of the investment tax credit and depreciation deductions from equipment leasing operations. None of the tax reducing effects of these provisions of the federal tax law is attributable to the enjoyment of a special provision by banks.

The more appropriate question is not what is the effective tax rate for banks, but whether banks are bearing their fair share of the burden of defraying the costs of government. The answer to that question necessarily involves a discussion of the contribution made by banks through excess earnings of the Federal Reserve System as well as the reduced rates paid by state and local governments on their borrowings.

Under the Depository Institutions Deregulation and Monetary Control Act of 1980 (P.L. 96-221), all banks and other depository institutions must now post reserves with the Federal Reserve System on an interest-free basis in direct ratio to their transaction accounts and nonpersonal time deposits. The reserves held by the Federal Reserve System are then invested primarily in government securities. While this is not thought of as a tax--because it directly generates revenue that is brought into the Treasury as miscellaneous receipts--it clearly represents a financial contribution by the banking industry to the revenues available to pay the direct costs of government. No other industry makes a parallel financial contribution. When the effective tax rate of banks is recalculated to reflect the earnings of Treasury on the reserves provided to the Federal Reserve System and by using a tax equivalent analysis of municipal bond income, they increase dramatically.

A recent study made by the Bank Administration Institute on 1982 tax data concluded that commercial banks have a far higher effective tax rate than is generally realized. According to BAI, the average effective tax rate for commercial banks is 43%. The figure includes the impact of two indirect--or implicit--taxes: the interest forgiven by banks on tax-free state and municipal obligations and the interest forgiven on mandatory reserves that banks are required to maintain with the Federal Reserve System. Bank earnings and income taxes were adjusted to reflect those implicit taxes in order to give a truer picture of a bank's tax situation.

The current tax code, for the most part, treats banks as any other corporate taxpayer. By purchasing tax-exempt bonds and engaging in leasing transactions, banks are merely fulfilling the role Congress has encouraged them to perform, that of financial intermediary, a conduit through which tax benefits flow to other taxpayers. Any changes to the provisions we have just mentioned might nominally increase the effective tax rate of banks, but the real economic burden would be on the state and local governments and the businesses that would no longer be able to afford the purchase capital assets.

We, the Associates of Robert Morris Associates, are directly involved every day with the lending and credit decisions at our respective financial institutions. We believe it is particularly inappropriate at this time to change from the reserve method of accounting for bad debts. A more realistic approach would be to include S. 1263 as part of any tax legislation. This bill was introduced by Senators Roth and Boren on June 7, 1985. It replaces the percentage method with a deduction based on the amount a bank charges against its earnings for loan loss reserve purposes. In other words, the book or financial statement reserve and the reserve for bad debts would be the same. In order to ensure that excessive reserves are not maintained, the bill provides an overall cap of 1.5% of loans on the amount of reserves for which a deduction may be taken.

Sincerely,

/dcl

The Sheet Metal and Air Conditioning Contractors' National Association, Inc.

SMACNA

STATEMENT OF LEE K. SCHWARTZ

TO

UNITED STATES SENATE
COMMITTEE ON FINANCE

ON

TAX REFORM

OCTOBER 4, 1985

SMACNA is a National Trade Association representing some 2500 sheet metal contractors engaged in the fields of heating, air conditioning, air pollution control, solar energy installation, architectural sheet metal and other metal applications. The sheet metal contracting industry totals over $8.6 billion annually.

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SMACNA STATEMENT ON TAX REFORM

Mr. Chairman, other members of the Committee, my name is Lee K. Schwartz, President of Mound Rose Cornice and Sheet Metal Works, St. Louis, Missouri. I am submitting these remarks on behalf of the Sheet Metal and Air Conditioning Contractors' National Association, Inc. (SMACNA), representing over 7,000 construction contracting corporations throughout the United States. The U.S. sheet metal contracting industry totals approximately $12 billion annually, approximately eight percent of total U.S. building activity in the commercial industrial sector. I am a former president of SMACNA, and the immediate past chairman of the Governmental Affairs Committee. I am very pleased to provide our recommendations to the Senate Finance Committee which will draft the Senate's version of the 1985 tax reform package.

When the Committee views the construction economy, it is important to understand its complexity and the large number of contractors, suppliers, subcontractors, laborers, etc. that are involved in the various independent sectors comprising the nation's construction market. If one examines the residential, commercial, and industrial construction markets and the many submarkets within each, it becomes clear how millions of large and small businesses and many millions more in total employees are involved in the overall construction sector of our economy which comprises approximately 14% of GNP or $350 billion this year alone.

While SMACNA consists of both large and small companies, a majority of our members are small businesses with a great concern for the level of interest rates, taxes, construction investment, and various other policies adopted by the federal government. Therefore we put forward our recommendations for the Committee's tax reform legislation.

THE ECONOMY

Clearly, the greatest problem for the construction industry is interest rates that are too high. While below the temporary peaks of the late 1970's, the average interest rates of the early 1980's have been far too high, especially in relation to the much lower inflation rate. In short, the record real interest rates inhibit investment and construction from reaching its potential. While the nation's overall construction economy has improved from the depths of the recent recession, larger deficits will cause higher interest rates and tight money, limiting construction activity. Current projections below 3% for economic growth in 1986 do little to encourage my industry that a significant growth period is immediately before us.

TAXES AND SMALL BUSINESS

Beginning in 1982, the federal government has passed at least one major tax bill each year designed to increase federal revenues. The 1982 legislation began the process of scaling back necessary construction investment incentives that were passed in the President's '81 Economic Recovery Tax Act, which SMACNA strongly supported. That trend continued last year with a tax package that is expected to raise over $50 billion over three years. The construction industry was adversely affected by a number of sections in last year's tax bill. Congress, with the President's approval, cut investment incentives for construction projects of various types. The reason for cutting the incentives was not because they were not necessary to stimulate investment but because more tax revenues were needed. Some of the 1981 tax incentives had yet to take effect when they were offered up for various revenue packages. Indeed, some provisions in the Reagan package, repeal or change the investment incentives even before the regulations have been issued.

SMACNA encourages the Committee to report out a bill which takes into consideration the negative impact of further decreases in investment incentives such as accelerated depreciation, leasing incentives, industrial development bonds, and investment tax credits for rehabilitation. These incentives are very important to millions of small businesses in the construction industry and their employees. While high interest rates caused by a growing federal debt harm construction, so do large increases in taxes, and so will excessive new taxes. We disagree with those who are suggesting even higher taxes on construction and business or elimination of investment incentives in order to bring down the cost of the current tax proposal.

The Committee's bill should recognize the large contribution of the construction industry to the nation's economy and the tax incentives that are needed to sustain its growth. In summary, higher taxes on construction are counterproductive to the nation's economic goals.

COMPLETED CONTRACT ACCOUNTING

First, I want to express our strong opposition to eliminating the completed contract method of accounting for small construction projects, as contained in the President's comprehensive tax reform plan for Congress. While eliminating the completed contract method accounting for construction projects is only a proposal by the President to Congress, we hope you will oppose eliminating this important accounting provision. Small construction projects should not be a scapegoat in your attempts to stop defense contractors from abusing contract rules!

The completed contract method of accounting has been used in construction since 1916. It was extensively revised by the IRS in 1976. At that time final regulations were published providing specific administrative rules for taxpayers electing the method. The regulations provided specific cost allocation rules for long-term contracts. Allocable contract costs are deducted in the year of final completion and acceptance of the contract and are called capitalized contract costs. Indirect contract costs which are not allocable to a contract are deducted in the year incurred and are called period costs. These rules are still used by virtually all construction contractors and were recently approved by the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA).

As mentioned above, the completed contract method of accounting was last revised by Congress as recently as 1982. The Congress was responding to a set of proposed changes from Treasury Department and, after lengthy hearings, adopted TEFRA. TEFRA set out specific directions for Treasury to publish regulations for modifying the completed contract method of accounting in order to better reflect income where changes were deemed necessary. The Administration's current proposed changes to the completed contract method are virtually identical to those rejected in 1982. Construction contractors with three year projects should not be considered the same as weapons contractors with long-term contracts, sometimes exceeding ten years. Construction has always been uniquely different from other industries that have used the completed contract method of accounting in that:

- Most construction is not done in a controlled environment such as a manufacturing plant or production facility.

- Each construction facility, whether it is a commercial building, a school, church or hospital, a dam, tunnel or water sewage treatment facility, is built to owner specifications, no two of which are alike.

- The variables of inclement weather, extreme variations in climate, soil conditions, location, multiplicity of materials specially manufactured for special projects, and providing other construction materials to frequently remote locations, all combine to make the construction industry unique.

- That uniqueness, unlike manufacturing industries or other indoor industries where multiple production of identical units is involved, is accentuated at the actual construction site where as many as 50 separate businesses can be engaged to produce what ultimately becomes a unique unit.

Individual specialty contractors on such sites are all at risk until project completion and acceptance by the owner, and it is that extension of risk until project completion that makes the completed contract method of accounting so vital in the construction industry. Studies by Data Resources Incorporated (DRI) and by the National Construction Industry Council indicate huge tax increases for small contractors will occur if the use of completed contract accounting is inhibited.

I want to emphsize that the construction industry has appeared before Congress many times in recent years regarding proposals restricting or eliminating the completed contract method of accounting. On each occasion Congress has dismissed these proposals as being inappropriate as they applied to construction contracts lasting less than 36 months or to contractors with less than $25 million in annual gross receipts. Congress recognized in TEFRA that "many small businesses would be unduly burdened by a requirement to allocate more indirect costs to long-term contracts." SMACNA asks you to support those recent decisions by the Congress, upholding the completed contract method of accounting. I have enclosed a copy, for the hearing record, of a publication explaining the completed contract method of accounting and why it is critical to the construction industry.

ENERGY TAX CREDITS

I want to also express our support for extending the energy conservation tax credits beyond their expiration at year's end. Three major bills with bipartisan support have been introduced in the 99th Congress to extend the credits: H.R. 2001, S. 1220, and S. 1305. SMACNA believes that any of these warrant the support of Congress as each extends the incentives necessary for encouraging solar, thermal, photovoltaics and other energy efficiency investments. While the Senate passed legislation during the 98th Congress and a majority of House members signed a resolution encouraging adoption of the Senate provision, the tax credit extension was not accepted by the House-Senate tax conference. Action is necessary now to sustain the momentum renewable and efficient energy technology have gained in our nation.

SMACNA, an association representing companies at the forefront of implementing energy management technology, has long placed top priority on increasing national energy conservation. As you know, by improving the efficiency of heating, ventilating and air conditioning systems, a substantial portion of energy waste can be prevented. With energy consumption and imports again increasing, Congress should maintain these tax incentives for installing more efficient energy systems and related conservation equipment. Clearly, an improved international balance of trade will result from effective tax policy in this important area.

SMACNA believes the federal government has a role to play in stimulating the utilization of energy conservation and solar energy technologies. More energy efficient businesses and factories will conserve significant financial resources which can be better directed to productive business investments. Federal energy and tax policy can thus improve the nation's economic growth, productivity and international trade position. We therefore ask your support for extending energy tax credits.

FRINGE BENEFITS

Specifically, SMACNA opposes taxes on fringe benefits. When depreciation incentives, industrial development bonds, leasing incentives, and other tax incentives are cut or eliminated, it hurts the construction economy. To add to the small business, and their employees, a new tax burden with fringe benefits taxes in order to pay for tax reform undermines employer-provided health, welfare, legal and dental programs.

If Congress believes that there is wide-spread abuse in the area of fringe benefits, it should say so, identify specific abuses, and make recommendations to correct them. But to tax fringe benefits, many of which are part of the social contract between the nation, employers and employees, solely to compensate for over-spending or unwise tax policy is unfair. SMACNA welcomes a Congressional or Administrative review of fringe benefit packages to seek out potential abuses. If found these abuses should be acted upon by Congress with support from the business community. But, again, we emphasize there cannot be abuses in defense contracts or other areas of the budget that are ignored if employer-employee fringe benefits are offered up for revenue purposes.

In a recently released report from its Small Business Administration Office of Advocacy, researchers examined the extent of coverage, characteristics, administrative practices and costs of pension and health care plans in small businesses. The SBA sudy found that benefits coverage is far less extensive for employees in small business than for workers in large businesses. Only 30 percent of employees in small firms (10 employees or less) have both health and pension benefits. In firms larger than 2,500 employees, over 95 percent of workers have both types of coverage. Insufficient profitability, benefit plan complexity, and plan costs all inhibit small business from providing or expanding benefit packages. Taxing the benefits will only cause businesses to reduce the number, extent, and variety of fringe benefit packages.

Most of our members assemble their benefit packages based on collective bargaining agreements. While these agreements vary from contract to contract, region to region, there are some similarities. The types of benefits range from job training assistance, education benefits, health and welfare benefits. In some areas travel benefits, journeyman upgrading, and scholarship funds are available. No matter what the benefit, it is very probable that if the benefits are taxed, employees acting alone or through their union representatives will seek greater benefits or higher wages to offset losses to income. The management-labor agreement may be subject to challenges as workers try to maintain an agreed upon wage and benefit package. Clearly, taxing fringe benefits will be an added financial burden on small business as labor passes on the costs of tax increases through to the business. The consumer then pays for the tax if the small business is able to pass on the added cost. Otherwise, it will become another burden for the business to absorb through reduced economic activity or lower profitability. Whatever is the result, we believe it is unwise to start a chain reaction of inflationary pressure through the overburdened small business community.

SMACNA believes that the driving force to tax fringe benefits and to increase taxes on a whole range of other small business activities is the desire to increase revenues. Taxing fringe benefits is not a proposal to increase the equity of the tax code or correct abuses but is simply a move to raise taxes to offset revenue losses in the President's tax plan.

REHABILITATION-PRESERVATION TAX CREDITS

Worthy ~~of~~ special opposition is the suggested repeal of the rehabilitation tax credits. This includes those targeted to buildings 30 and 40 years old, in addition to certified historic structures. For many of the nation's cities this has been the major urban policy initiative of the last four years. Passed in 1976 and augmented in 1981, the rehab tax credits have been responsible for billions of dollars in construction and thousands of new jobs. Many examples where city and state revenues were increased by rehabilitating old center cities can be seen across the U.S. In less than four years the credits have been responsible for over $5 billion invested in approximately 7,000 buildings. Therefore, Congress has a tax policy that works and increases federal, state and local tax revenues while improving and preserving the urban fabric.

The preservation/rehab industry is an important part of the U.S. economy and the construction industry. Approximately $21 billion per year is reinvested in privately owned buildings more than 50 years old. Older and historic commercial properties are particularly attractive investments capturing almost half of all the reinvestment money. However, residential rehabilitation is also a booming business: In some areas of the country, the amount invested each year in existing buildings is 25 percent greater than the amount spent on new housing construction. Evidence strongly indicates that the reinvestment industry is growing in absolute and relative size. During slumps in new housing construction, more resources are devoted to mprovingexisting buildings; however, as new house construction revives, housing reinvestment does not fall back. Instead, there is a steady flow of investment money for improvements to existing housing.

SMACNA represents small contracting firms throughout the nation. According to a National Trust survey, more than 60% of smaller construction firms are involved in rehabilitation work, almost half of which are general or subcontractors. More than three-fifths of all firms (more than 35,000 firms) with an annual volume up to $500,000 did rehabilitative work according to the Trust survey.

Preservation projects are very labor intensive, provide training and enhance the skills of those involved. Furthermore, once employed, workers on preservation and rehabilitation are not subject to the normal fluctuations of the construction industry as most of the renovation is completed in an enclosed area.

As mentioned, historic preservation is often more labor intensive than new construction. The type of work involved in rehabilitation is repair and replacement--working around and within an existing structure. This type of work requires fewer materials than new construction but more skilled labor. In short, rehabilitation creates more jobs for a given investment than does new construction.

Figures collected for 1,169 Urban Development Action Grant (UDAG) projects show that projects involving historic preservation consistently created the most construction jobs--17.7 per million dollars expended. This is 35 percent more jobs than UDAG projects that did not involve preservation, which created only 13.1 construction jobs per million dollars expended.

We agree with President Reagan's remarks September 14, 1984 which state, "our tax credits have made the preservation of our older buildings not only a matter of respect for beauty and history, but of good economic sense." The President has accurately showcased the rehab credits as a supply-side incentive generating far more in investment and subsequent tax revenues than they cost in expenditures. For example, in New York state, a study calculated that $100 million in rehabilitation projects generated $10 million in direct revenues for the state and its localities creating 5,000 new jobs. In Illinois, a recent study found that since the inception of the 25 percent credit in 1981, owners involved in 141 projects invested over $323 million in rehab expenditures creating 16,106 new jobs and increased the Illinois state GNP by $1.12 billion. Personal earnings growth on these projects totaled $325 million. (Advisory Council on Historic Preservation Report, 1984)

In my home state, Missouri, we have experienced a major rehabilitation and preservation boost to the economy. From 1977 to 1984, surveys indicate that up to $400 million was invested utilizing the rehab incentives. In fact, Missouri ranked as one of the most frequent users of the rehab incentives. Missouri was exceeded, however, by Illinois, New York, Pennsylvania and Massachusetts. However, we are proud that St. Louis led the nation in 1983 with 350 in tax-act projects. Currently, a $140 million restoration of Union Station is underway which will turn an abandoned 11 acre wasteland of rusting metalwork and broken glass into a showplace for the nation. Without the credits the restoration would never have been envisioned. Clearly, new jobs, new tax revenues and the saving of an architectural masterpiece all were made possible by the 1981 tax credits. SMACNA feels that the rehab incentives represent an effective urban tax policy that is a tremendous success. Therefore, it should not be undermined or repealed.

CONCLUSION

In addition to the areas of the tax reform package mentioned above, economic studies and our business experience and intuition all reinforce our serious belief that the tax reform package will have a strong negative impact on the construction economy and national productivity, by lengthening depreciation schedules, eliminating of tax exempt bonds directed toward construction, eliminating investment tax credits and terminating the deduction for state and local taxes. Eliminating high-powered, targeted investment incentives to pay for general stimulus tax cuts will reduce investment productivity and construction employment while increasing the national debt.

We are very apprehensive about supporting this or any tax legislation which increases the federal deficit and interest rates. While it appears to economists and those in our industry that the overall impact on construction will be very negative, we are awaiting the final DRI details mentioned earlier before we express opposition or support for potentially harmful portions of the plan. As mentioned, the construction industry study will present the Congress with the only detailed analysis of how the tax plan affects construction and its suppliers. We will be back to you with the study once it is completed and anticipate you will utilize its findings in drafting your Committee bill.

In conclusion, I thank the Committee for allowing our industry to comment on the tax package. SMACNA encourages you to undertake a closer examination of how the proposal will affect construction investment and employment before the Committee expedites a bill to the floor. Construction is a major factor in the domestic economy with a significant impact on many related industries. To move legislation before all the facts and studies on the bill are known may create more problems than tax reform was designed to solve.

Thank you.

STATEMENT OF FRANCIS R. CARROLL
PRESIDENT

FOR THE
SMALL BUSINESS SERVICE BUREAU, INC.
NATIONAL OPERATIONS CENTER

544 MAIN STREET
P.O. BOX 1441

WORCESTER, MA 01601

BEFORE THE
SENATE COMMITTEE
ON
FINANCE

OCTOBER 4, 1985

REGARDING
ENTERTAINMENT EXPENSES

THE SMALL BUSINESS SERVICE BUREAU, INC. IS A NATIONAL ORGANIZATION FOR SMALL BUSINESSES WITH OVER 35,000 MEMBERS. SBSB PROVIDES SMALL BUSINESSES AND NEW BUSINESS START-UPS WITH LEGISLATIVE ADVOCACY, MANAGEMENT ASSISTANCE AND OTHER GROUP BENEFITS AND SERVICES.

THE RECENT TREASURY TAX REFORM PLAN WILL PLACE EVEN GREATER BURDENS UPON THE BUSINESS COMMUNITY BY CAPPING BUSINESS MEALS DEDUCTIONS ON A PER PERSON BASIS, AT $10 FOR BREAKFAST, $15 FOR LUNCH AND $25 FOR DINNER, INCLUDING TAX AND TIP. THE IRS PROPOSES TO PUNISH THE MAJORITY OF BUSINESS PEOPLE WHO USE THIS DEDUCTION HONESTLY BECAUSE OF THE FEW WHO ABUSE THIS PRIVILEGE. BUSINESS MEALS ARE A LEGITIMATE, PROPER ACTIVITY. MANY IMPORTANT BUSINESS DEALS AND DECISIONS ARE MADE OVER WORKING BREAKFASTS, LUNCHES AND DINNERS. THE BUSINESS MEAL IS A TOOL ESSENTIAL IN CONDUCTING BUSINESS, NOT A FRIVOLOUS PERK. THE "THREE MARTINI LUNCH" IS A BIG BUSINESS, NOT SMALL BUSINESS PHENOMENON. SMALL BUSINESS PEOPLE WASTE NEITHER THEIR TIME OR MONEY ON LIQUID LUNCHES.

CONSIDER ALSO THAT LIMITING BUSINESS MEAL DEDUCTIONS WILL ADVERSELY AFFECT RESTAURANTS WHICH RELY ON BUSINESS CLIENTS FOR A SUBSTANTIAL PORTION OF THEIR BUSINESS. FOR SMALL RESTAURANT OPERATIONS, THIS COULD MEAN DISASTER. TAXING BUSINESS MEALS WILL HURT RESTAURANTS AND SALES REPRESENTATIVES, WHO MAKE UP A SUBSTANTIAL PROPORTION OF SMALL BUSINESSES. THE IRS SHOULD IMPROVE ITS ENFORCEMENT OF THE CURRENT LAW. IT IS INTERESTING TO NOTE THAT THE USE OF LIMOUSINES IS STILL PROTECTED AS A LEGITIMATE DEDUCTIBLE BUSINESS EXPENSE FOR CORPORATE EXECUTIVES IN THE ADMINISTRATION'S TAX PLAN.

THE LIMITATIONS IMPOSED ON BUSINESS MEAL DEDUCTIONS DO NOT TAKE INTO ACCOUNT REGIONAL PRICING DIFFERENCES. TAKING A CLIENT TO LUNCH IN NEW YORK OR WASHINGTON, D.C. IS MORE EXPENSIVE THAN DINING A CLIENT IN PEORIA. IN ADDITION, THE LACK OF AN INDEXING ELEMENT FOR INFLATION WILL SOON DEVALUE A CAPPED DEDUCTION, EVENTUALLY RENDERING IT WORTHLESS.

ALTHOUGH THE TAX REFORM PROPOSAL IS DESIGNED TO COMBAT TAX DEDUCTION ABUSES, SBSB FEELS ITS BUSINESS LUNCH PROVISIONS WILL ULTIMATELY CREATE GREATER STRESS ON THE ECONOMY. THE CAP ON THE BUSINESS MEAL, WHICH IS A LEGITIMATE BUSINESS PRODUCTIVITY TOOL, WILL ADVERSELY AFFECT AN EFFORT TO CURB TAX DEDUCTION ABUSES. INSTEAD, LOST REVENUE TO THE GOVERNMENT IN STATE, SALES, SOCIAL SECURITY AND FEDERAL INCOME TAXES WILL FAR OUTWEIGH THE PERCEIVED TAX REFORM BENEFITS BY REDUCING RESTAURANT INCOME AND SIGNIFICANTLY INCREASING THE NUMBER OF PEOPLE COLLECTING UNEMPLOYMENT COMPENSATION.

DURING THE 1980 CAMPAIGN, PRESIDENT REAGAN VOICED STRONG SUPPORT FOR CONTINUING THE FULL DEDUCTIBILITY FOR BUSINESS MEALS. WE ASK TODAY THAT THE ADMINISTRATION AND CONGRESS ADHERE TO THAT COMMITMENT.

TESTIMONY OF

N. JEROLD COHEN, ESQ.

OF

SUTHERLAND, ASBILL & BRENNAN

on

PROPOSED REQUIREMENT THAT PROVIDERS OF SERVICES BE REQUIRED TO CHANGE FROM THE CASH METHOD OF ACCOUNTING TO AN ACCRUAL METHOD

(CHAPTER 8.03 OF THE PRESIDENT'S TAX PROPOSALS TO THE CONGRESS FOR FAIRNESS, GROWTH AND SIMPLICITY)

before the

COMMITTEE ON FINANCE
OF THE
UNITED STATES SENATE

OCTOBER 4, 1985

Mister Chairman and Members of the Committee, my name is N. Jerold Cohen. I am a partner in the law firm of Sutherland, Asbill and Brennan which has offices in Atlanta, Georgia and Washington, D. C. I served as Chief Counsel of the Internal Revenue Service during the period from October 1979 through January 1981. I appreciate the opportunity to appear today to speak on behalf of a coalition of service organizations which, under present law, properly compute their incomes according to the cash method of accounting.

I. Introduction

Under the President's Tax Proposal, businesses and professional organizations with annual gross receipts in excess of $5 million (determined on a 3-year moving average) or who use an accrual method in reporting to shareholders or creditors would be prohibited from using the cash method of accounting. (Chapter 8.03). That provision, which in fact is directly contrary to the President's intended purposes, should not be adopted for the following reasons:

- It is manifestly unfair to a broad range of service businesses which, under current law, properly report their incomes on the cash method. It would both discriminate arbitrarily among these taxpayers based merely on their size, and discriminate against the service industry as a whole as compared to manufacturers and sellers of goods.

- It will severely retard growth by encouraging taxpayers to seek to avoid its $5 million "trigger" by delaying revenue-producing transactions, by avoiding growth or by subdividing operations.
- It will replace a simple, easily understood, and long accepted tax accounting method with one of substantial complexity without providing any offsetting benefits. In so doing, the proposal has the potential to foster substantial disrespect for the entire tax system.
- In addition, the proposed "transition" rule is in reality a targeted six-year excise tax imposed on the assets of enterprises required to make the change, regardless of the amount of their current taxable incomes, or, indeed, regardless of whether they in fact have any current taxable income.

Unless either the proposed provision is rejected, or the "transition" rule is substantially modified in one of the ways discussed in this testimony, the effect of the provision would be to impose an unfair cash burden on a designated group of taxpayers, simply because of a legislative requirement that they change from one permissible method of accounting to another. This is arbitrary and contrary to traditional standards of fundamental fairness in regard to tax legislation.

While the Proposal suggests there are policy reasons for the required change, the proposed provision is so inconsistent with well-established and fundamental tenets of tax accounting (specifically, that the appropriate time to levy the tax is when the taxpayer has the funds with which to pay it and that taxpayers should not be forced to borrow to pay their tax obligations), so discriminatory in its application, and so inconsistent with other provisions of both the Proposal and the Internal Revenue Code as to suggest that its true objective is merely to exact a tax from the designated group in a short period of time. Meanwhile most taxpayers, including smaller service businesses (assuming they do not violate the provision's "conformity" rule), would continue to file their returns on the traditional basis of cash accounting. The burdens on taxpayers required to make the change would not be a true income tax at all, but instead would be a targeted six-year excise tax, since it would be levied on an asset accumulated over time, regardless of current income, and regardless of the persons who owned the asset, or were responsible for its growth.

II. Basic Differences in the Cash and Accrual Methods

Under the cash method, income is recognized in the year when it is received in cash (either actually or constructively), and expenses are deducted in the year they are paid. As such, the cash method is the simplest and most certain method of accounting for both income and expense. It is based on the fundamental premise that the tax should be collected when the taxpayer has the cash to pay it, neither sooner nor later. The method historically has been recognized as presumptively correct for service businesses.[1]

Under an accrual method, inventories and other items of income and expense are generally taken into account when "all events" have occurred which fix either the right to receive the income or the obligation to pay an expense, and the amount thereof can be determined with "reasonable accuracy." However, a number of special rules have been developed to permit cash flow tax reporting by accrual method sellers of goods (e.g., the installment sales method provided by section 453A of the Internal Revenue Code); to permit such sellers to take inflation into account in computing the deduction for cost of goods sold (LIFO accounting and the proposed indexing of FIFO); and to protect the government from the loss of revenue from "premature accruals" (section 461(h), added to the Code by the Tax Reform Act of 1984). In addition, in order to protect the public fisc, both the Internal Revenue Service and the courts have generally required accrual method taxpayers to report prepaid income on the cash method.

A long standing rule of convenience and common sense holds manufacturers or sellers of goods must maintain inventories and use an accrual method. This is because, under the Code, income is measured by "gain" on the sale of property, rather than by "gross receipts." In order to compute such gain accurately, selling prices must be matched with the cost of goods sold. Although this could be done under the cash method, the computation is much simpler if inventories are kept, and an accrual method is used. It is very important to understand, however, that the special tax accounting provisions discussed above which are applicable to accrual method taxpayers have the practical effect of making available to manufacturers and sellers of goods treatment comparable to that now available to service businesses using the cash method.

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[1] Under existing law, the Commissioner of Internal Revenue has broad discretion to require a taxpayer to change from a method of accounting which does not "clearly reflect income." Numerous court decisions and public and private rulings of the Internal Revenue Service recognize that for the service industry, the cash method meets this test. Of course, the Commissioner has properly exercised his authority to require a change in cases where the taxpayer has abused the method.

The Treasury's concern behind the President's proposed limitation on the use of the cash method is apparently based on the theory that it permits a "deferral" in the reporting of income which would be eliminated under the accrual method. By treating accounts receivable as "realized" income which must be currently recognized rather than as an asset which measures income which will be recognized when actually or constructively received, the accrual method can, as compared to the cash method, accelerate the recognition of income and the collection of tax. In essence, then, the Treasury is proposing to substitute theoretical economic concepts of income "realization" in place of a time-tested, simple and practical means of income "recognition." For tax purposes, common sense, practicality and ability to pay should take precedence over economic theories of wealth accumulation. To do otherwise would add unnecessary complexity and would be counterproductive in terms of respect for and compliance with the tax system.

In any event, Treasury's concern is at best overstated, and it fails to recognize at all the Proposal's severe unfairness on service businesses and professional groups. In fact, the deferral in income recognition which is an inherent feature of the cash method (because, in general, in the marketplace services are paid for after they are performed, and not before) occurs in the first year the method is used, and thereafter only as and to the extent that the "spread" between accounts receivable and accounts payable grows; if the spread remains static, the income reported will be exactly the same under both the cash and accrual methods, and as the spread decreases, whether because of improved collection procedures or a decrease in volume, more income will be reported on the cash method than on an accrual method. In general, any "deferral" under the cash method (as compared to the acceleration in recognition of income by accrual method taxpayers who do not elect an installment method) is very short term -- merely the time it takes to bill and collect for services rendered.

III. Taxpayers Affected

The cash method of accounting is the traditional method of reporting income used by thousands upon thousands of professional and commercial service organizations. The General Explanation to the Proposal suggests that the provision would apply only to a few taxpayers, such as banks and large accounting, law and advertising firms. This Explanation greatly understates the reach of the provision. In fact, the proposal would directly affect the entire service sector of the economy--contractors, plumbers, electricians, temporary help services, maintenance services, repair crews, insurance claims adjusters, credit reporting agencies, television and radio broadcasting stations, architects, engineers, health care providers, doctors and dentists are only some of the taxpayers who would be affected. The group we represent includes a representative cross-section of such organizations.

Two members of this group -- the Private Diagnostic Clinic and the Emory Clinic -- are large medical partnerships consisting of hundreds of physicians associated with the medical schools of Duke and Emory Universities. Three members are proprietary hospital concerns which provide medical, surgical and psychiatric care to patients at hospitals they own or manage. Other members of the group are corporations which provide a variety of services, including supplying information to business users, insurance adjusting, and either soliciting or broadcasting advertisements. These and countless other similarly situated taxpayers in service businesses and professional groups would be greatly prejudiced by a forced change to an accrual method of computing income, as well as by the proposed imposition of a tax on accounts receivable without regard to income. Thus, we are seeking to maintain the right of a taxpayer engaged in a service business to continue to use the cash method to account for the operations of that business.

IV. The Proposal is Unfair.

The cash method of accounting should be retained because it is the simplest, and most clearly understandable method of accounting for tax purposes. The public fisc is protected because, in all cases, the tax is collected when the taxpayer has the cash with which to pay the tax. While accounts receivable may be a measure of the accumulation of wealth, they cannot be "spent" -- whether to pay taxes or otherwise -- until collected. Taxes cannot be paid by the assignment of accounts receivable, and there is no sound reason to force taxpayers to borrow to meet their tax liabilities.

An underlying premise of the proposal is that it would place sellers of goods and providers of services on the same method of accounting for tax purposes. This is not true. Sellers of goods, who are otherwise required to report on an accrual basis because they maintain inventories, may elect to use the installment method of section 453A[2] to postpone reporting income for tax purposes until the time when cash payment for these goods is actually received. Sellers of goods thus are effectively permitted to report income from such sales on the cash method; that is, after they have received the cash with which to pay the tax. However, this installment method of reporting is not presently available (and under the present proposal would not be available) to providers of services.

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[2] Section 453A of the Internal Revenue Code of 1954, as amended (the "Code"). Use of the installment method is broadly available at the option of accrual method manufacturers and sellers of goods. The prior approval of the IRS is not required. The option is available to sales requiring two or more payments, sales for which two or more payments are contemplated (even if actually paid in one payment) and revolving credit sales.

We do not quarrel with the continued availability of the installment method, but the proposed distinction between the seller of goods and the provider of services is illogical and unfair. A seller of goods can repossess the item sold if the customer refuses to pay. This safeguard is not available to a provider of services. Thus, in effect, the proposal would continue the availability of the equivalent of the cash method in situations where the likelihood of ultimate collection of the accounts receivable (or protection against loss) is great, but deny it where collectibility is, in general, much less certain.3/

There are yet other rules which permit accrual method taxpayers to postpone reporting income despite receipt of a cash payment. Sections 455 and 456, for example, permit magazine publishers and certain membership organizations to defer reporting certain subscription and dues income which has already been received in cash. If enacted, then, the proposal would create an anomaly: a television station which derives the bulk of its revenues from the service of broadcasting advertisements, and receives payment for this service after the advertisements

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3/ The proposed repeal of the reserve method for bad debts (Chapter 8.04) would compound the problem of service organizations.

have run, would be required to treat such revenues as income before receipt, but a magazine (which is competing for the same advertising dollars) would be permitted to defer reporting subscription revenues as income even though such revenues have actually been received in cash.

V. The Provision Will Penalize and Inhibit The Growth of Business Enterprises Now Properly Using the Cash Method.

The provision also draws an arbitrary, and unfair, distinction between similarly situated taxpayers by basing eligibility for use of the cash method on the volume of average gross receipts. The Emory Clinic and the Private Diagnostic Clinic at Duke, for example, could structure their operations as a number of separate, small partnerships, one for each medical specialty. (With such a subdivision, it would be likely that the revenues of each such small group would be less than $5 million, and hence conversion to the accrual method would not be required.) This approach was considered when the partnerships were formed many years ago, and was rejected because of the economies of scale attainable with a single "umbrella" partnership, particularly in terms of simplicity for patients referred from one specialty group to another, more efficient and economical use of physician time and equipment, and reduced administrative costs. The arbitrary distinctions created by the proposal would place great pressure on the partners in these enterprises to subdivide into small partnerships in order to avoid the tax burden which would be imposed by this provision.

Similar considerations would apply to a growing business enterprise. A plumbing concern with, for example, four locations each grossing $1 million should not be faced with a tax penalty which would inhibit it from adding a fifth location. A tax law which has economic efficiency as one of its professed aims should not include a strong incentive to a business to shrink in size, to refrain from growth, or to fragment in order to avoid a discriminatory tax burden and to continue to be taxed on the same basis as others who are engaged in the same business activity and who earn the same amount of income. We can find no basis in logic and no justification in terms of an equitable uniform application of the tax law to subject professionals and other service providers in the very same business, and making precisely the same amount of income, to different rates or schemes of taxation merely because one practices with more colleagues than the other or has more employees than the other. The introduction of such a concept, which would have potential application to a large number of taxpayers, would have the certain effect of creating disrespect for the system.

The arbitrary $5 million distinction creates other problems of fairness. One of the companies we represent, for example, changed its method of accounting from the accrual to the cash method in 1954, with the express permission of the Internal Revenue Service. That permission was grounded upon the Service's recognition that, for a company whose business is the provision of services, the cash method of accounting clearly reflects income. The company's use of the cash method was challenged by an Internal Revenue Agent in 1974, and the question was referred to the National Office, which concluded, "The growth of the [taxpayer], standing alone, is not a basis for the Service to now hold that the cash receipts and disbursements method does not clearly reflect income." Ltr. 7405291610B. A legislative mandate that the company change to an accrual method now would, under the proposed transition rules, penalize it in future years for its proper use of the cash method in the past. This penalty would be based in large part on the company's size and growth in prior years, the very grounds which the Internal Revenue Service recently determined not to be an adequate basis to require a change to an accrual method in those years.

The proposal would also create severe problems to taxpayers whose businesses are cyclical. Such a taxpayer could be forced to change to an accrual method because of growth during a comparatively short period, and may then be unable to secure the Commissioner's consent to change back to the cash method, despite a period of gross receipts of less than $5 million. In that circumstance, under the proposed "transition" rules, the business would be required to include in income over a six year period the "spread" accumulated in prior years despite the current downturn. An even greater problem will exist for organizations struggling to remain profitable. Such organizations may have little or no income, as determined under cash or accrual accounting, yet be required to pay substantial taxes because of the transition rule.

VI. Contrary to the Expressed Intent of Promoting Simplicity, the Proposal Would Add Complexity to the Tax Code

The cash method represents a certain computation of income. Particularly in the case of a service business, where the rendition of services occurs over time, it is not certain what the income will be until it is received. The certainty of cash method reporting -- pursuant to which income is always reported when received and expenses deducted when paid -- may be contrasted to various conventions which permit accrual method taxpayers who sell goods to postpone reporting income until the cash is received (section 453A) or, in certain circumstances when such income is received in advance of sale, at the time of sale (Treas. Reg. § 1.451-5).

Because income for an accrual method taxpayer is recognized only when all events have occurred which fix the right to receive income and the amount thereof can be determined with reasonable accuracy, the time of recognition is dependent upon the provisions of applicable contracts, business custom and the like. This results in great variation in reporting. Sellers may accrue income at any of several points in time; for example, when the manufacture of goods is completed, when the goods are shipped, when they are invoiced, or when they have been delivered. With the cash method, there is no need to attempt to find whether the right to receive income has become "fixed and determinable." Under the cash method, the test is simple: Income is recognized when received.

Service businesses, especially those of the size which the proposal would require to be converted to an accrual method, generally make every reasonable effort to collect promptly their accounts receivable, and they do not prepay expenses. There is no suggestion to the contrary, and no indication of any abuse of the cash method of accounting by taxpayers. Hence, there is no basis for a general disallowance of the use of the method. (As in the past, any cases of abuse may be dealt with on an individual case basis, just as is done in cases of abuses in the use of the accrual method.)

VII. The Proposal Will Not Cure the Perceived Problem of "Mismatching"

The President's report suggests that the proposal will cure the "mismatching" which occurs when an accrual method purchaser of services deducts the amount of an invoice submitted by a cash method provider of services, but the cash method provider does not include the same amount in income because payment has not yet been received. This "concern" is a red herring. It ignores, of course, the "reverse mismatching" which is created when the user of the services -- such as an individual receiving medical care -- is on the cash method and cannot deduct until paid amounts which an accrual method provider of services would have to take into income when invoiced. It also ignores the fact that, as pointed out above, under accrual methods of accounting, income and expense may be recognized at varying points in time. Placing both sides to a transaction on an accrual method will not necessarily produce "matching."

When Congress has recently examined other situations involving short-term "mismatching" of various items of income and expense, it has properly avoided imposing needless complexity in the name of theoretical purity. (See, for example, section 467, section 461(h)(3)(A)(ii), and sections 1272-1275 which exempt short-term differences in treatment in situations involving prepaid rent, recurring payments made in the ordinary course of business, and original issue discount from mandatory "matching" rules. The same approach is followed in sections 482 and 483.)

Finally, the proposal appears premised on the mistaken belief that accrual accounting for tax purposes is in accord with (or more in accord with) economic concepts of income recognition and generally accepted accounting principles than the cash method. This is not necessarily the case, since accrual tax accounting is not consistent with accrual financial accounting.[4/] As the Supreme Court recognized in Thor Power Tool Co. v. Commissioner 439 U.S. 522 (1979), tax and financial accounting have different purposes and employ different characterizations of

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[4/] For example, use of the installment method by accrual basis sellers of goods is not in accord with GAAP.

various items. To be equitable and fair, and to protect the public fisc, tax accounting must give great weight to ability to pay, to the certainty of income and expense recognition and to similar well established doctrines. Financial accounting is vastly different in objective and approach. It is disingenuous to suggest that cash method accounting is not consistent with GAAP and should therefore be denied while at the same time refusing to accept GAAP (or providing exceptions to GAAP) for use by accrual method taxpayers, particularly those engaged in the sale of goods.[5]

VIII. The Proposed "Transition" Rules are Inappropriate, Unfair and Constitute a Hidden, Targeted Tax

The proposed "transition" rules would require taxpayers now properly using the cash method of accounting to switch to an accrual method. They would also require these taxpayers to include in income ratably over a period not to exceed six years the accummulated "spread;" that is, generally speaking, the accummulated differerce on the effective date between accounts receivable and accounts payable. This proposal -- which may be a strong motivating force behind the provision -- amounts to an unprecedented attempt to impose a hidden, targeted tax increase on a designated group of taxpayers who have heretofore properly used the cash method of accounting.[6]

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[5] A part of the proposal is to deny the use of the cash method to taxpayers, regardless of their size, if they "regularly" use accrual statements to report to shareholders and creditors. This part of the provision would reach virtually every provider of services who routinely borrows money and completes a financial statement in which the bank asks for information on accounts receivable. It is ironic that the proposal would impose a conformity requirement here, but at the same time would eliminate the conformity requirement in the case of LIFO, where it has been historically required.

As pointed out earlier, except for business growth or contraction, reported income from continued operations is exactly the same for an accrual method taxpayer and a cash method taxpayer. The on-going operations under the cash method do not produce a significant difference in the amount of taxable income when compared to the accrual method, but the transition from one accounting method to another, and the proposed inclusion of the accumulated spread in income, would produce a major distortion in the computation of the incomes of these taxpayers. The presently existing spread was, in many cases, built up over a long period of years. Technically, the amount of this spread, which is known as a section 481 adjustment, is the amount of income that would have been taxed in years prior to 1986 had the taxpayer been using an accrual method in those years. If viewed as a tax on income, the only income that is technically being taxed is the income that would have been earned under the new method in years prior to 1986. The transition adjustment thus amounts to a retroactive application of the new method to years prior to 1986. This is most unfair, particularly since it is the present owners of the business who will be forced to bear this tax, rather than those who were owners during the years in which the spread was accumulated.

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[6] For example, a typical service business might have from six weeks to two months of uncollected charges in its accounts receivable balance at year end. The proposal would subject such a business to an additional tax, levied on an amount ranging from approximately 11.5% to 16.67% of an entire year's income, with the tax spread over six years. In reality, this would be an excise tax, since it would be due regardless of whether the business had any net income -- under either the accrual or cash method -- in the year the tax was imposed. The effect is magnified for an individual, because of the income brackets under the Proposal. Under the Proposal, a married physician with taxable income of $70,000 would pay tax of $14,000, or an effective rate of 20%. If $30,000 of accounts receivable -- built up by his predecessors in practice over prior decades -- were attributed to him, he would be taxed on an additional $5,000 per year for the next six years, although he would never receive these funds. His annual tax on this amount would be $1,750, causing his effective tax rate to go up from 20% to 22.5%, an increase in rates of more than 10% for the six year period.

This can easily be seen in the case of the Emory Clinic and the P.D.C. at Duke, which have been in operation for more than 20 and 50 years, respectively. The partners who are now in these groups would be taxed currently on the amount of year-end receivables built up (and, under an accrual method, earned) by their predecessors over several decades. This amount of per partner receivables is, of course, a constant figure, changing only in specifics. It is not converted into cash available to pay tax (because the year-end balance of receivables which are collected in the following year are replaced with a new balance of receivables at the end of that year, and so on), but remains "invested" in the ongoing enterprise. The effect is the same on the present-day shareholders of corporations or partners in other businesses using the cash method, who would be required to suffer the diminution in value of their investments on account of the taxation of accrued balances built up over long periods of years under a thoroughly acceptable method of accounting for tax purposes.

Traditionally, the imposition of a tax on the spread has occurred in only two circumstances. The first is where a taxpayer voluntarily requests a change in method. In such a case, the taxpayer agrees in advance to imposition of the transition adjustment. This makes it easier for the Service to grant the requested change without having to spend inordinate time determining whether approval of the change will result in any abuse. The second is where the method being changed is incorrect or improper. The adjustment is necessary to make certain that correction of the prior use of the incorrect method does not permit income to escape taxation. Neither circumstance exists here. Taxpayers are certainly not seeking a voluntary change in method (even though the Proposal contemplates that the change will be treated as one that is initiated by the taxpayer). The Proposal also recognizes that use of the cash method was neither incorrect nor improper during the years used. Thus, there is no justification for imposition of a tax on the spread. Moreover, it is misleading and distorting to propose that the accrual method be effective for years beginning in 1986 while at the same time using a transition rule to place taxpayers on an accrual method retroactively--i.e. to put them on an accrual method for all years prior to 1986.[7]

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[7] We anticipate that, in response to this required use of an accrual method, many partnerships will develop accrual method record keeping for partners. This record keeping will be costly (footnote continued)

Congress was faced with a somewhat similar problem when the change in accounting method provisions of section 481 were enacted as part of the 1954 Code. There, even where the methods of accounting being changed were improper (and, hence the Commissioner had obvious authority to require such changes), pre-1954 receivables were excluded from income. No less should be done here, where taxpayers are properly using the cash method in accord with current law, and often with the Commissioner's express permission. A similar approach was followed in 1984 in connection with the "fresh start" provision of the Life Insurance Companies Tax Act. It was also followed for accrual method manufacturers using LIFO when the full absorption regulations under section 471 were promulgated in 1974.

For the reasons stated in this testimony, we feel strongly that the adoption of the proposal would be unwarranted and discriminatory. However, if the proposal is adopted, we recommend that accounts receivable accumulated prior to the date of enactment, net of related accounts payable, not be subject to taxation. Under this approach, any subsequent growth in accounts receivable would be fully includible, so that an expanding business would have more income subject to tax in the year of change and thereafter than would be the case if it remained on

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(footnote continued from previous page)
and yet, once the transition period is over, the revenue projections suggest that there are no meaningful reasons to require accrual accounting and the keeping of such records, since the per partner receivables may not be much different under an accrual method than under a cash method. If this is correct, costly annual record keeping would have been instituted for the transition period only. This does not make sense.

the cash method. This approach should fully satisfy any policy reasons for the proposed change, since it accomplishes the objective of placing affected taxpayers on an accrual method for 1986 and subsequent years while not penalizing them for being on the cash method in prior years.

Alternatively, if the proposal were enacted, taxpayers could be required to maintain the spread as it existed prior to the date of enactment in a "suspense account" and bring it into income as required under current law; that is, when the size of the balance is reduced, or the business is liquidated and the spread is thereby eliminated. (In concept, this is similar to the LIFO method for inventories.) This approach is consistent with current law because it preserves the cash method of accounting for receivables accrued prior to the date of enactment, but puts the new law, and the mandated accrual method, fully into effect on the date of enactment.

Finally, it is clear that under any circumstances a six year transition period is drastically too short, and would work an economic hardship on taxpayers required to make the change. Certainly a fundamental change in an overall method of accounting should receive the maximum period for transition for which there is precedent: namely, the 20-year period which had been available for many years for changes from LIFO accounting.

IX. Conclusion

The combination of installment reporting and available techniques of inventory cost accounting gives accrual method sellers of goods essentially the same "deferral" now permitted to cash method providers of service. Requiring cash method providers of services to shift to a new and more complicated method of accounting simply because of a perceived need to deny them a "deferral" permitted to other taxpayers is manifestly unfair. The certainty of the cash method pursuant to which taxpayers recognize income and pay tax when and as they have received cash should be retained. And, in any event, there is no basis for singling out these taxpayers and imposing on them the harsh and arbitrary exaction of a targeted excise tax.

STATE BAR OF TEXAS

SECTION OF TAXATION

July 26, 1985

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The Honorable Bob Packwood
Chairman, Senate Committee on Finance
United States Senate
219 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Senator Packwood:

Enclosed are five copies of resolutions setting forth the position of the Section of Taxation of the State Bar of Texas opposing the proposal, which was included in The President's Tax Proposals of May 29, 1985, to require larger personal service businesses to use accrual accounting in computing taxable income. I request that these resolutions be included in your Committee's formal record with respect to The President's Tax Proposals.

On behalf of the Section of Taxation of the State Bar of Texas, I wish to express my thanks for the Committee's consideration of our position on this matter.

Very truly yours,

W. John Glancy

W. John Glancy
Chairman, Section of Taxation

WJG:222
Enclosure

STATE BAR OF TEXAS
SECTION OF TAXATION

CERTIFICATE OF RESOLUTIONS

I, Stanley L. Blend, certify that I am the Secretary of the Section of Taxation of the State Bar of Texas and that on June 29, 1985, the Council of the Section of Taxation of the State Bar of Texas duly adopted the following resolutions, which remain in full force and effect:

> RESOLVED, that the Section of Taxation of the State Bar of Texas recommends that the Congress reject the proposal, which was included in The President's Tax Proposals of May 29, 1985, that would require many personal service businesses that now compute taxable income on the cash method of accounting to convert to the accrual method of accounting.
>
> FURTHER RESOLVED, that the Section of Taxation of the State Bar of Texas believes that the proposal to require certain personal service businesses to use accrual accounting for federal income tax purposes would not properly measure the income of such businesses and would inequitably discriminate against the businesses subject to such requirement.
>
> FURTHER RESOLVED, that the officers of the Section of Taxation of the State Bar of Texas are authorized to present the foregoing position to members of Congress and to appropriate committees of Congress.

IN WITNESS WHEREOF, I have hereunto set my hand as Secretary of the Section of Taxation of the State Bar of Texas this 29th day of June, 1985.

Stanley L. Blend

Stanley L. Blend